ABOUT THE AUTHORS

CA Jai Chawla

CA JAII CHAWLA is the core faculty of **V'Smart Academy, Pune and D7 Fortune Classes, Bhopal**

He has a leading experience of more than 12 years of CA INTER ADVANCE ACCOUNTS & CA FINAL FINANCIAL REPORTING and has guided more than 1,20,000 students across India. His Quality of teaching and friendly behavior along with the tendency to guide and help each student in the best possible ways, makes him so loving among the students

His vision is to share his knowledge and skills to benef t the students and inculcate the tendency of learning and enchanting knowledge which may lead them towards the success.

His Chart Revisions & Question Bank discussion videos on Youtube are very popular across India.

Dammini Jai Chawla

DAMMINI JAI CHAWLA is the co-founder and proud owner of D7 FORTUNE CLASSES, BHOPAL. She is the First Class MBA degree holder & a student of CA Final and CS Professional.

Her management and communication skills made D7 FORTUNE, a known brand in a short span of 2 years. She is also engaged in counseling & managment and doubt clearing sessions of INTER in D7 FORTUNE CLASSES. She has devoted and dedicated her crucial time in supporting her husband to all the possible extent. She believes in CA JAI CHAWLA'S dream and vision as her own.

She is the **Co-author of various Books of CA FINAL FINANCIAL REPORTING and CA INTER ADVANCE ACCOUNTS.**

PREFACE

DEAR STUDENTS,

Hi Friends
Cheers to the moment!
When I am delighted to introduce this before you, 'TRUMP'. Yes it will be a trump card for students .haw?

This is the book which will provide **an in-depth understanding** of “Accounting Standards” along with multiple Concept Builder Examples.

This book is one stop destination for covering all Accounting Standards thoroughly in a very short span of time.

This compilation would not be a reality without the immense efforts of my wife DAMMINI JAI CHAWLA, and this is her idea to provide to the dearest students, having the primary objective to create a friendly relation of student with the books and it is very important to divide and compress the book into concised form in a Simple and Student Freindly language.

This book covers all the Accounting Standards of CA INTER with all the concepts **including Question Solving Techniques**. This handy book can be carried anywhere and is sufficient to understand logics with conceptual clarity.

This will ease your way to score better marks than your expectations.
And finally, a special thank to my Parents Shri Girish Chawla (Father), Smt. Kanchan Chawla (Mother).

Also, a very heartfelt thanks to my Previous batch students **specially students of Nov. 23 Batch (aka Safed Chuhe Batch) and Jan’25 Batch (aka Extra-ordinary batch), to whom I have introduced multiple examples and conceptual summaries of AS** so that to incorporate in this book for the better understanding and practice and I am glad that they were more enthusiastic and energetic to help me with this mission.
It’s the students who make us and keep us going.

It well be immense pleasure for me, to receive your views and feedback on this book on the number mentioned below.

At Last I would say one thing to all of you - तुम सब लगे रहो मैं तुम्हारा अंत तक साथ दूंगा !

YOUR DOST MENTOR & GUIDE
CA. JAI CHAWLA
7887 7887 05

How To As
DOUBTS

HOW TO ASK STUDY RELATED DOUBTS ?

1. You can WhatsApp yourQuery/Doubt along with the image of Question and Solution if any. (7887 7887 05)

2. Normally Me & My Team will try to reply within a day or two but pls have some patience for 3-4 days, after that u can call us on the same number to remind if u haven't got any reply.

3. Doubts will be entertained only on WhatsApp orDedicated Telegram Groups of the batch if any.

Let's Stay Connecte

Subscribe our Youtube Channels for Video

Jai Chawla Sir

V'Smart Academy

Connect with Me for Free Resources

CA. Jai Chawla
Telegram Channel

CA. Jai Chawla
Whatsapp Channel

Lets Follow Each other on Insta

INDEX

Remaining Topics are Covered in AS Trump Volume 2

1 INTRODUCTION TO ACCOUNTING STANDARDS

Quote:
"If you are not willing to risk the usual, you will have to settle for the ordinary."

1. INTRODUCTION ON ACCOUNTING STANDARDS

1) What is GAAP?
It's a Generally Accepted Accounting Principles

2) In India, GAAP = Accounting Standards (AS) and Indian Accounting Standards (IndAS).

3) Accounting Standards = Policy Documents Covering –
Recognition, Measurement, Presentation & Disclosure in Financial Statements

4) Why there is a need to Accounting Standards?

- To Provide useful Information to Investors & Other Stakeholders.
- AS reduces the alternate treatments in Financial Statement. So that Comparability of F/S can be easy.
- Requirement of Additional Disclosures to understand the Financial Statement better.
- To reduce the scope of Creative A/c (Twisting the Accounting Policies to produce Favorable Financial Statements)

5)

ICAI (Leadership Role in AS)

⇩

Accounting Standards Board (1977)

⇩

ASB = Members of ICAI + Representatives of Different Industries + Regulators (NFRA) + Govt Department

⇩

ASB Submits the draft to NFRA

⇩

NFRA recommend the AS to MCA

⇩

MCA Finally issued the AS for Companies

ASB Considers IAS/IFRS; Applicable Laws; customs & Business environment in India while Formulating any A/c Treatment.

6) Standards Setting Process: -

Area Identification

⇩

Constitution of Study Group

⇩

Draft Preparation

⇩

Ascertaining View on Draft

⇩

Finalization of Exposure Draft (ED)

⇩

Comments received on ED

⇩

Modification of Draft

⇩

Final AS is Issued

7) There are total 27 Accounting Standards effective and applicable at present.

2. OVERVIEW OF ACCOUNTING STANDARDS

Enterprises to which the accounting standards apply?

1) AS applies to all enterprises (corporate, non-corporate, or other forms like LLP, Cooperative societies)
2) AS applies to Profit as well as Non-profit entities.
3) However, any organization which is solely carrying such activities which are not at all commercial, industrial or business nature may not apply AS.
4) 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.

2.1 ACCOUNTING STANDARDS FOR NON-COMPANY ENTITIES

Level I Entities:

Non-company entities which fall in any one of the following categories at the end of relevant accounting year are called as Level I entities:

- Entities Whose Securities are listed or are in process of listing on any stock exchange, whether in India or outside India.
- Banks (Including Co-Operative Banks), financial Institutions or entities carrying on insurance Business
- All commercial, industrial and business reporting entities whose turnover is greater than 250 crores in the immediately preceding accounting period. Here other income is to be ignored in calculation of turnover.
- All commercial, industrial and business reporting entities whose borrowings including public deposits in excess of 50 crores at any time during the immediately preceding accounting year.
- Holding and Subsidiary entities of any 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 Level II entities.

- All industrial, commercial and business reporting entities whose turnover exceeds rupees 50 crores but doesn't exceed rupees 250 crores in the immediately preceding accounting year.
- All commercial, industrial and business reporting entities whose borrowings including public deposits are above 10 crore but doesn't exceed 50 crores at any time during the immediately preceding accounting year.
- Holding and Subsidiary entities of any one of the above.

Level-3 entities:

Non-company entities which are not Level I and Level II entities but fall in any one or more of the following categories are Level III entities.

- All industrial, commercial and business reporting entities whose turnover exceeds rupees 10 crores but doesn't exceed rupees 50 crores in the immediately preceding accounting year.
- All commercial, industrial and business reporting entities whose borrowings including public deposits are above 2 crore but doesn't exceed 10 crores at any time during the immediately preceding accounting year.

- Holding and Subsidiary entities of any of the above.

Level-4 entities:

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

2.2 ACCOUNTING STANDARDS FOR CORPORATE ENTITIES: (Companies AS Rules, 2006)

SMALL AND MEDIUM SIZED COMPANIES (SMEs): 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;
- **Entities whose turnover does not exceed Rs. 250 crores** in the immediately preceding accounting period. Here other income is to be ignored in calculation of turnover.
- **Entities whose borrowings including public deposits are not in excess of Rs. 50 crores at any time** during the immediately preceding accounting year.
- **Which is not a holding or subsidiary** company of a company which is not a small and medium sized Company.

NON SMCs:

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

NEED FOR CONVERGENCE TOWARDS GLOBAL STANDARDS i.e. IFRS

Raising Funds from International Market	Comparability of Financial Statements	Uniformity and Transparency	Global Investments

Technique I – Adoption Process: Adoption would mean that the country sets a specific timetable when specific entities would be required to use IFRS as issued by the IASB.

Technique II – Convergence Process: Convergence means that the country will develop high quality, compatible accounting standards and there would be **alignment of the standards of different standard setters with a certain rate of compromise**, by adopting the requirements of the standards either fully or partially. Ind AS are almost similar to IFRS but with few carve outs so as to make them suitable for Indian Environment.

What are Carve Outs & Carve Ins in INDAS ?

Carve Outs: 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'.

Making Changes in A/c Treatment given in IFRA due to Change in Economic Environment.

Carve Ins: Additional guidance given in Ind AS over and above IFRS

3. ROADMAP FOR IMPLEMENTATION OF INDIAN ACCOUNTING STANDARDS?

APPLICABILITY OF IND AS FOR COMPANIES (OTHER THAN BANKS, NBFCs, INSURANCE COMPANIES)

Phase-I: Obligation to Comply with Ind AS from 1st April, 2016

In accordance with clause (ii) of sub- rule (1) of Rule 4 of the Companies (Indian Accounting Standards) Rules, 2015, the following companies shall comply with Ind AS w.e.f. April 2016:

(a) Companies listed/in process of listing (Except companies listed on SME Exchanges) on Stock Exchanges in India or Outside India having net worth of ₹500 crore or more;

(b) Unlisted Companies having net worth ≥ ₹500crore;

(c) Holding (Parent), subsidiary, joint venture or associate companies of above.

COMPLIANCE	CURRENT FY	COMPARATIVE PERIOD	TRANSITION DATE FOR OPENING IND AS BS
Voluntary Compliance (Optional)	FY 15-16 i.e. year ending 31st March 2016	FY 14-15 i.e. year ending 31st March 2015	01/04/2014
Mandatory Compliance	FY 16-17 i.e. year ending 31st March 2017	FY 15-16 i.e. year ending 31st March 2016	01/04/2015

Phase-II: Mandatory Compliance of Ind AS from 1st April, 2017

Clause (iii) of sub- rule (1) of Rule 4 of the Companies (Indian Accounting Standards) Rules, 2015 states that the following companies shall comply with Ind AS for the accounting periods beginning on or after 1st April, 2017:

(a) Companies listed/in process of listing (Except companies listed on SME Exchanges) on Stock Exchanges in India or Outside India having net worth of less than Rs. 500crore;

(b) Unlisted companies having net worth of ≥ Rs.250 crore but < Rs.500crore;

(c) Holding, Subsidiary, Associate and J.V. of Above.

COMPLIANCE	IND AS CURRENT FY	IND AS COMPARATIVE PERIOD	TRANSITION DATE FOR OPENING INDAS BS
Voluntary Compliance (Optional)	FY 16-17 i.e. year ending 31st March 2017	FY 15-16 i.e. year ending 31st March 201 6	01/04/2015
Mandatory Compliance	FY 17-18 i.e. year ending 31st March 2018	FY 16-17 i.e. year ending 31st March 2017	01/04/2016

Note:

- Ind As once required to be complied shall apply to both standalone financial statements and consolidated financial statements.

- Overseas subsidiary, associate, joint venture and other similar entities of an Indian company may prepare its standalone financial statements in accordance with the requirements of the specific jurisdiction, provided that such Indian company shall prepare its consolidated financial statements in accordance with Ind AS either voluntarily or mandatorily if it meets the criteria.

- Indian company which is a subsidiary, associate, joint venture and other similar entities of a foreign company shall prepare its financial statements in accordance with the Ind AS either voluntarily or mandatorily if it meets the criteria. (based on Net Worth of Individual Financial Statements of Subsidiary).

- Listing Status shall be checked only in First Year of INDAS Financial Statements.

- Subsidiary/Associates/JV status shall be checked only in the First Year of INDAS Financial Statements.

IND AS FOR BANK, INSURANCE COMPANIES AND NBFCS

S.No.	Entities	For Accounting Period Beg. Frm 1st April 2018 onwards	For Accounting Period Beg. Frm 1st April 2019 onwards	For Accounting Period Beg. Frm 1st April 2021 onwards
1	All India Term lending refinancing Institutions (EXIM, NABARD, SIDBI)	Mandatory	-	-
2	Non Banking Financial Institutions (NBFCs)	Having Net Worth of Rs. 500 Cr. or More Holding, Subsidiary, JV or Associates of the above	NBFCs whose equity/debt instruments are listed or in process of listing and having Net Worth Less than Rs. 500 Cr. Unlisted NBFCs, Having Net worth of Rs. 250 Cr. or more but less than Rs. 500 Cr. Holding, Subsidiary, JV or Associates of the above	-
3	Insurance Companies	IRDAI, vide circular dated 21 January 2020, has deferred implementation of Ind AS in the insurance sector till further notice.		
4	BANKS (Excluding RRBs)	Implementation of IndAS is deferred till further Notice by RBI vide Notification dated 22/03/19		

Notes:

1. Voluntary adoption is not permitted for BANKs/NBFCs/INSURERS
2. Entities not covered in the roadmap shall continue to apply Accounting Standards at present.

4. MCQs from ICAI Resources

Q1. Phase I of Ind AS was applicable to:

(a) All listed companies in India or outside India

(b) Companies with turnover INR 500 crores or more

(c) Companies with net worth INR 500 crores or more.

(d) Companies with turnover INR 250 crores or more

Q2. IASB stands for

(a) International Accounting Standards Bureau

(b) International Advisory Standards Board

(c) International Accounting Standard Board

(d) International Accounting System Board

Q3. IFRS stands for

(a) International Financial Reporting System

(b) International Finance Reporting Standard

(c) International Financial Reporting Standard.

(d) International Financial Reserve Standard

Q4. Additional guidance given in Ind AS over and above what is given in IFRS are called

(a) Carve-outs.

(b) Carve-ins.

(c) Carve clarifications.

(d) Clarifications

Q5. Non – cooperative entities which are not Non-corporate entities which are not Level I entities whose turnover (excluding other income) exceeds rupees exceed rupees-------- but does not two-fifty crores in the immediately preceding accounting year classified as Level ||I entities.

(a) five crores.

(b) two crores.

(c) fifty crores.

(d) ten crores.

Q6. All non-corporate entities engaged in commercial, industrial and business reporting entities, whose turnover (excluding other income) exceeds 250 rupees in the immediately preceding accounting year, are classified as:

(a) Level I entities.

(b) Level II entities.

(c) Level III entities.

(d) Level IV entities

Q7. The following Accounting Standard is not applicable to Non-corporate Entities falling in level Il in its entirety

(a) AS 10.

(b) AS 17.

(c) AS 2.

(d) AS 13.

Q8. Small and Medium Sized Company (SMC) means, a company

(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;

Q9. 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.

(a) Level III entities.

(b) Level IV entities.

(c) Level II entities.

(d) Level I entities.

Correct Answer								
Q1	**Q2**	**Q3**	**Q4**	**Q5**	**Q6**	**Q7**	**Q8**	**Q9**
a	c	c	b	c	b	b	b	c

Student Notes:-

2 ACCOUNTING STANDARD – 1
DISCLOSURE OF ACCOUNTING POLICIES

"Failure doesn't mean the game is over, it means try again with Experience"

1. WHAT IS ACCOUNTING POLICY?

Meaning: The accounting policies refer to the:

- Specific Accounting Rules and
- the methods

adopted by the entity for the preparation and presentation of financial statements.

Examples of Accounting Policies to prepare financial statements:

Items to be disclosed	Method of disclosure or valuation
Inventories	FIFO, Weighted Average etc.
Cash Flow Statement	Direct Method, Indirect Method
Measurement of PPE	Cost Basis or Revaluation Basis
Measurement of Investments	Cost Basis or Market Value Basis
Measurement of Revenue from Service Contracts	% of Completion Method (or) Completed Contract Method

An Extract from the Annual Report of Infosys Ltd. for the year ended 31st March, 2023:

Notes to Standalone Financial Statements

2.1 Property, plant and equipment

Accounting policy

Property, plant and equipment are stated at cost, less accumulated depreciation and impairment, if any. Costs directly attributable to acquisition are capitalized until the property, plant and equipment are ready for use, as intended by the Management. The charge in respect of periodic depreciation is derived at after determining an estimate of an asset's expected useful life and the expected residual value at the end of its life. The Company depreciates property, plant and equipment over their estimated useful lives using the straight-line method.

The estimated useful lives of Assets are as follows:

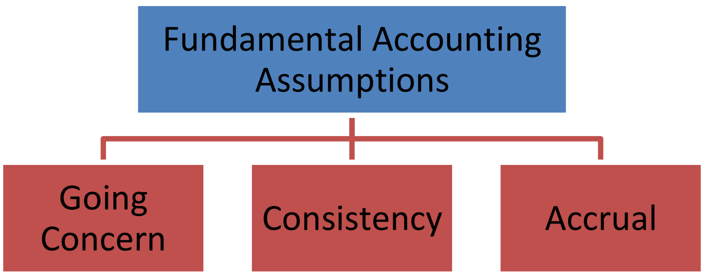
Building	22-25 Years
Plant and Machinery	5 Years
Office Equipment	5 Years
Computer Equipment	3-5 Years
Furniture and Fixtures	5 Years

Vehicles	5 Years
Lease hold Improvements	Lower of Useful life of Asset or Lease Term

- Based on technical evaluation, the Management believes that the useful lives, as given above, best represent the period over which the Management expects to use these assets. Hence, the useful lives for these assets is different from the useful lives as prescribed under Part C of Schedule II of the Companies Act 2013.
- Includes solar plant with a useful life of 25 years.
- Depreciation methods, useful lives and residual values are reviewed periodically, including at each financial year end. The useful lives are based on historical experience with similar assets as well as anticipation of future events, which may impact their life, such as changes in technology.

2. IMPORTANT PROVISIONS OF AS 1

1. **All** significant Accounting Policies adopted in the preparation and presentation of financial statements should be disclosed.
2. The disclosure of Significant Accounting policies as such should form part of financial statements and the significant accounting policies should normally be disclosed at one place.
3. According to AS – 1 there are three fundamental accounting assumptions:



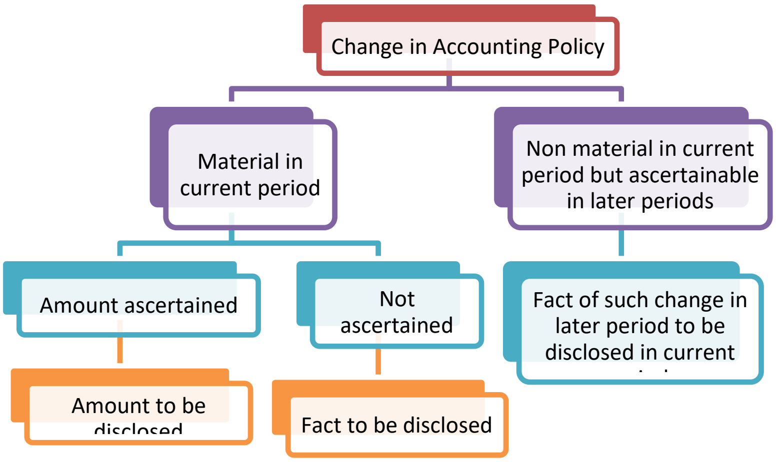
4. If the fundamental accounting assumptions are followed in the financial statements, specific disclosure is not required. If a fundamental accounting assumption is not followed, the fact should be disclosed.

5. While selecting any accounting policy following three principles should be considered:
   - **Substance over Form:** Actual reality or substance of a transaction is more important than just how it looks on paper.
   - **Materiality:** Only information that is significant enough to affect decisions should be included in financial statements.
   - **Prudence:** When there is uncertainty its better not to recognise potential gains but to make provisions for potential losses in future. **(Note: Refer Example 1)**

6. **Changes in Accounting Policies:** An enterprise can change its accounting policies & presentation only when any of the following three conditions are satisfied:
   - Adoption of different accounting policy is required by any statute/law. (or)
   - Adoption of different accounting policy is for the purpose of compliance with an accounting standard.
   - It is considered that change would result in more appropriate presentation of financial statements.

7. Disclosure of Change in Accounting Policy:

- A simple disclosure that an accounting policy has been changed is not of much use for a reader of a financial statement. The effect of change should therefore be disclosed wherever ascertainable.
- Any change in accounting policies which affects the financial statements of current period, or which is reasonably expected to have effect in later periods' financial statements, then such change should be disclosed.
- The amount by which such change affects the financial statements should also be disclosed to the extent ascertainable i.e. the change should be quantified in the financial statements.



(Note: Refer Example 2 below)

3. IMPORTANT EXAMPLES

Example 1 (ICAI Module): Prudence

The most common example of exercise of prudence in selection of accounting policy is the policy of valuing inventory at lower of cost and net realisable value.

Suppose a trader has purchased 500 units of certain article @ ₹10 per unit. He sold 400 articles @ ₹15 per unit. If the net realisable value per unit of the unsold article is ₹15, the trader shall value his stock at ₹10 per unit and thus ignoring the profit ₹500 that he may earn in next accounting period by selling 100 units of unsold articles. If the net realisable value per unit of the unsold article is ₹8, the trader shall value his stock at ₹8 per unit and thus recognising possible loss ₹200 that he may incur in next accounting period by selling 100 units of unsold articles.

Profit of the trader if net realisable value of unsold article is ₹15

= Sale – Cost of goods sold = (400 x ₹15) – (500 x ₹10 – 100 x ₹10) = ₹2,000 Profit of the trader if net realisable value of unsold article is ₹8

= Sale – Cost of goods sold = (400 x ₹15) – (500 x ₹10 – 100 x ₹8) = ₹1,800

Example 2 (ICAI Module): Effect of Change in Accounting Policy

A company has switched from FIFO to Weighted average formula for ascertaining cost of inventory. If the closing inventory by FIFO is ₹2 lakh and then by weighted average formula is ₹1.8 lakh, the change in accounting policy pulls down profit and value of inventory by ₹20,000. The company may disclose the change in accounting policy in the following manner:

"The company values its inventory at lower of cost and net realisable value. Since net realisable value of all items of inventory in the current year was greater than respective costs, the company valued its inventory at cost. In the present year the company has changed to weighted average formula, **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 profit and value of inventory by ₹20,000".

4. MCQ's from ICAI Resources

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

2. Adoption of different accounting policies by different companies operating in the same industry affects which of the qualitative characteristics the most?
   (a) Comparability
   (b) Relevance
   (c) Faithful representation
   (d) Reliability

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?
   (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 should be appropriately disclosed only in the later periods i.e. year(s) next to the year in which the change is adopted.

ANSWERS	1	2	3
	b	a	d

5. MCQ's Created by Jai Sir and Team

4. Fundamental accounting assumption is
   (a) Materiality
   (b) Business Entity
   (c) Going concern
   (d) Dual aspect

5. Which of the following is included in the consideration for selection of accounting policies:
   (a) Going concern
   (b) Consistency
   (c) Prudence
   (d) Accrual

6. All significant Accounting Policies are disclosed
   (a) In Auditors' Report
   (b) In notes to Accounts of the financial statements
   (c) Board of Directors Report
   (d) Audit Committee Report

7. The major considerations governing the selection and application of accounting policies are
   (a) Prudence.
   (b) Substance over form.
   (c) Materiality.
   (d) All of the three.

ANSWERS	4	5	6	7
	c	c	b	d

3 ACCOUNTING STANDARD – 2
VALUATION OF INVENTORIES

Quote:

"One who takes all pains will enjoy all pleasures"

1. DEFINITION OF INVENTORY

Inventories are **Assets:**

(a) Held for sale in the ordinary course of business (Finished Goods)

(b) In the process of Production for Such Sale (WIP) or

(c) In the form of materials or supplies to be consumed in the production process or in the rendering of services (Raw Material).

2. NON - APPLICABILITY of AS 2

AS-2 is not applicable to following cases.

- Work in process in the construction contract business including, directly related to service contract (AS 7)
- Any financial instruments held as stock in trade which includes shares, debentures, bonds etc.
- Other inventories like livestock, agricultural product and forest product, natural gases and mineral oils etc.
- Work in progress in the business of banking, consulting and service business. That means it includes incomplete consulting service, merchant banking service and medical service in process.

3. MEASUREMENT OF INVENTORY AT BS DATE

At the lower of

Cost | *Net realisable Value*

Note: If nature of Inventory is agriculture **Crops or Minerals,** then these can be measured **at NRV only** if sale is assured & No risk of failure to sell is there.

4. NET REALISABLE VALUE

- NRV is the Estimated Value.
- The actual transaction price (i.e. customer order price or sale price) after the balance sheet date could be the best available evidence to identify NRV of Finished Goods or Stock in Trade.

In Respect of Finished goods:

Normal selling price of the Finished Goods	XXX
Less - Estimated Expenditure to sale such goods	XXX
Net Realisable Value	XXX

In Respect of WIP:

Normal selling price of the Finished Goods	XXX
Less - Estimated Expenditure to sale such goods	XXX
Less – Estimated further Cost to Make Finished Goods	XXX
Net Realisable Value of WIP	XXX

Measurement of Raw Material:

If Finished goods sold at Cost or Above	If Finished goods sold at below Cost
Estimated Realisable value of Raw material and supplies is considered more than cost. Therefore, Raw Material should be measured at Cost.	Estimated Realisable value of Raw material or supplies may be less than Cost. Therefore, Raw Material should be measured at Replacement Cost or Original Cost whichever is Lower.

Note: - If Some Quantity of Inventory is promised to be sold under the customer order, then NRV of that portion of inventory shall be the Agreed Order Value and NRV of remaining portion shall be general selling price.

Example 1:
Computers and laptops on 31/03/20X1:- 150 units
Normal Selling Price:- Rs.1,20.000/- per unit
On 30/04/20X1, customer order for supply of 100 units @ Rs.95000/-per unit
Calculate the NRV of total 150 units.

Solution: -

Sr. No.	Particulars	Amounts
1	100 units X 95,000	9,50,000
2	50 units X 1,20,000	60,00,000
	Total NRV	**1,55,00,000**

Example 2:

Cost of a partly finished unit at the end of 20X1 – X2 is Rs. 150. The unit can be finished next year by a further expenditure of Rs. 100. The finished unit can be sold at Rs. 250, subject to payment of 4% brokerage on selling price. Assume that the partly finished unit cannot be sold in semi-finished form and its NRV is zero without processing it further.

The value of inventory will be determined as bellow:

	Rs.
Net selling price	250
Less: Estimated cost of completion	(100)
	150
Less: Brokerage (4% of 250)	(10)
Net Realisable Value	140
Cost of inventory	150
Value of inventory (Lower of cost and net realisable value)	140

5. COST OF INVENTORY

There can be three types of cost are included in the inventory which are as follow.

1. PURCHASE COST:

- Invoice price at which goods are purchased
- Duties and taxes paid
- Transport, Handling and Freight inward
- Any other expenditure directly relating to acquiring goods or services

Above cost should be reduced by following:

- Duties and taxes received or receivable back from the tax authority
- Trade discount
- Rebate
- Duty drawback

Note :-

- Primary packing charges of material is included in cost.
- Secondary packing and publicity charges of material is recorded as Selling expense in Statement of P&L

2. COST OF CONVERSION (Labour + Production Overhead)

- Direct Material, Labour and other direct expense.
- Plus **a systematic allocation of fixed and variable production overheads** that are incurred in converting materials into finished goods.

Following things should be considered for conversion cost of the inventory.

(a) **FIXED PRODUCTION OVERHEAD** –

For example – **depreciation and maintenance of factory building.**

Allocation of fixed expense should be made on the bases of normal capacity

If production levels are abnormally low	Unallocated overheads are recognized as an expense (P&L)
If production levels are abnormally high	Amount of Fixed O/H allocated to each unit is decreased so that inventory should not be measured above cost.

(b) **VARIABLE OVERHEAD** –

Variable production overheads are allocated to each unit of production based on the actual use of the production facilities.

3. OTHER COST:

It includes any other expenditure incurred to bring inventory in the present location and condition. For eg. Transportation cost from factory to warehouse for storage of goods.
But rent for such warehouse is not other cost & not a part of cost measurement.

Exclusion in Cost of Inventory - But it should not include abnormal wastage relating to material and labour, storage cost, administrative expenses & selling and distribution expenses, finance element in case of deferred settlement.

Example 3 on allocation of Overheads:

Pluto ltd. has a plant with the normal capacity to produce 5,00,000 unit of a product per annum and the expected fixed overhead is Rs. 15,00,000. Fixed overhead on the basis of normal capacity is Rs. 3 per unit (15,00,000/5,00,000).

Case 1:

Actual production is 5,00,000 units. Fixed overhead on the basis of normal capacity and actual overhead will lead to same figure of Rs. 15,00,000. Therefore, it is advisable to include this on normal capacity.

Case 2:

Actual production is 3,75,000 units. Fixed overhead is not going to change with the change in output and will remain constant atRs. 15,00,000, therefore, overheads on actual basis is Rs. 4 p/u (15,00,000/3,75,000).

Hence by valuing inventory at Rs. 4 each for fixed overhead purpose, it will be overvalued and the losses of Rs. 3,75,000 will also be included in closing inventory leading to a higher gross profit then actually earned.

Therefore, it is advisable to include fixed overhead per unit on normal capacity to actual production (3,75,000 x 3) Rs. 11,25,000 and balance Rs. 3,75,000 shall be transferred to

Profit & Loss Account.

Case 3:

Actual production is 7,50,000 units. Fixed overhead is not going to change with the change in output and will remain constant atRs. 15,00,000, therefore, overheads on actual basis is Rs. 2 (15,00,000/ 7,50,000). Hence by valuing inventory at Rs. 3 each for fixed overhead purpose, we will be adding the element of cost to inventory which actually has not been incurred. At Rs. 3 per unit, total fixed overhead comes to Rs. 22,50,000 whereas, actual fixed overhead expense is only Rs. 15,00,000. Therefore, it is advisable to include fixed overhead on actual basis (7,50,000 x 2) Rs. 15,00,000.

IMPORTANT ISSUE IN RELATION TO COST OF INVENTORY:

Issue 1:

If payment for Cost of Inventory is to be made beyond Credit Terms (say payment after 1 year), then what should be the Cost of Inventory?

Answer:

Cost of Inventory should be = Present Value of Future Cash Outflow (discounted) also known as Cash price equivalent (i.e. current selling price)

Issue 2:

What should be the Treatment of Spare Parts, Standby Equipment and Servicing Equipments purchased and used in PPE?

Answer:

Case I: If they meet the definition of PPE as per AS 10: Recognised as PPE.

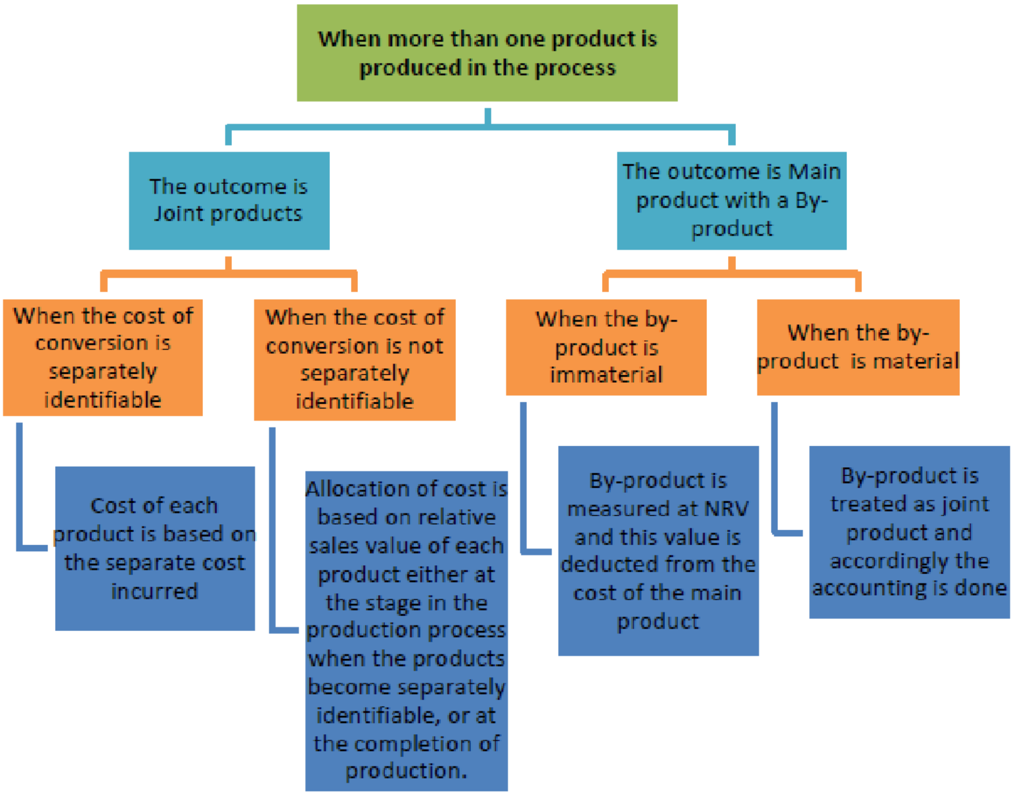
PPE a/c Dr.
To Bank a/c

Case II: If they do not meet the definition of PPE as per AS 10: Such items are classified as Inventory as per AS 2.

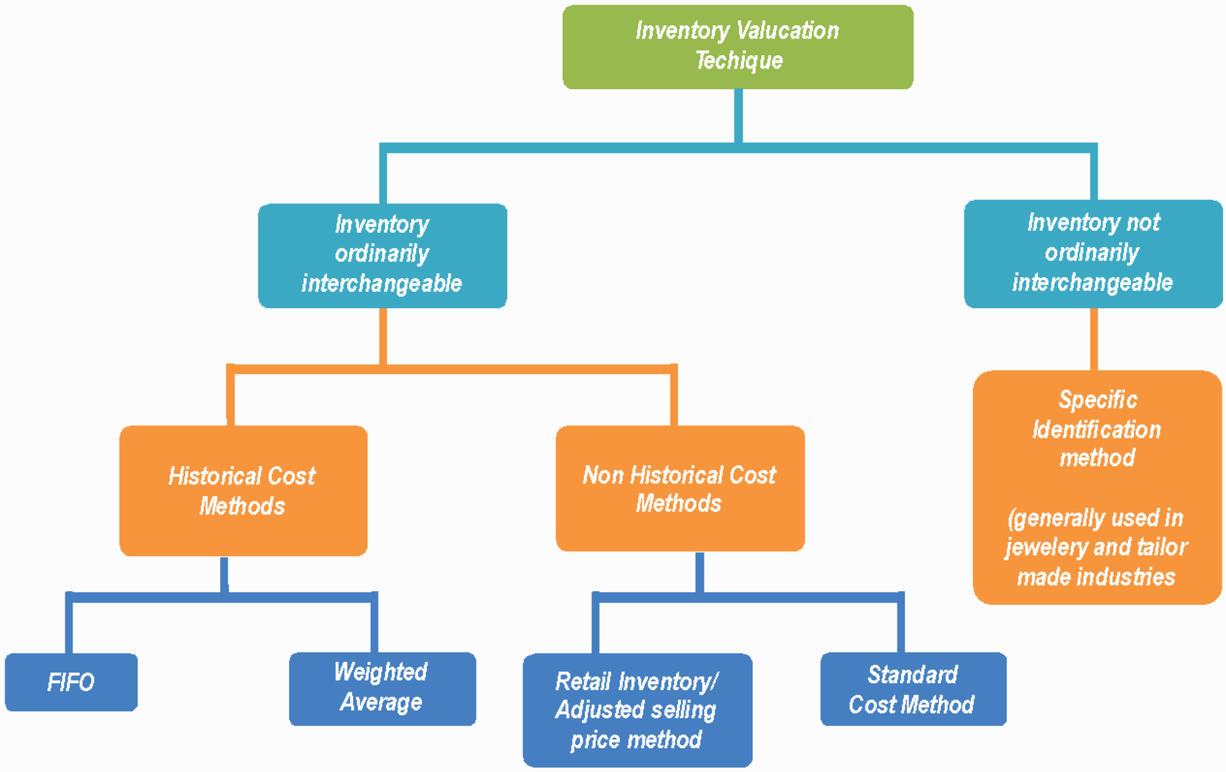
Purchase a/c Dr.
To Bank a/c

(At balance sheet date, if they are not yet fully consumed then shall be included under Inventory and Measured accordingly as per AS 2)

6. ALLOCATION OF COST TO JOINT PRODUCTS AND BY-PRODUCTS



7. TECHNIQUES OF MEASURING THE COST



(i) Standard Cost Method: Cost is based on normal levels of materials and supplies, labour efficiency and capacity utilization. Standard Rates of Material, labour and overheads are taken each month to measure the inventory.

(ii) Retail Method: Cost is determined by reducing the sales value of the inventory by the appropriate percentage gross margin. This method is often used in the retail industry for measuring inventories of rapidly changing items that have similar margins.

Note: AS 2 Inventories ***does not permit using LIFO (last-in-first-out).***

Imp Issue: Whether an entity can use different cost formulae for the inventories held at different geographical locations?

Answer:

AS 2 states that an entity shall use the same cost formula for all inventories having a similar nature and use to the entity. For inventories with a different nature or use, different cost formulas may be justified.

Also, difference in geographical location of inventories does not justify the use of a different cost formula, if the inventories are of similar nature and use to the entity.

Example 4:

A trader purchased certain articles for Rs. 85,000. He sold some of articles for Rs. 1,05,000. The average percentage of gross margin is 25% on cost. Opening stock of inventory at cost was Rs. 15,000. Cost of closing inventory is shown below:

	Rs.
Sale value of opening stock and purchase (Rs. 85,000 + Rs. 15,000) × 1.25	1,25,000
Sales	(1,05,000)
Sale value of unsold stock	20,000
Less: Gross Margin (Rs. 20,000 / 1.25) × 0.25	(4,000)
Cost on inventory	16,000

TRADE DISCOUNT & CASH DISCOUNT

- **Trade discount** should be **deducted** to determine the Cost of Inventory.
- **Cash discounts** are incurred to recover the sale proceeds immediately or before the end of the specified period or credit period allowed to the customer. Therefore, the same should **not be considered** while determining NRV.

8. MCQ's from ICAI Resources

1. Which item of inventory is under the scope of AS 2 (Revised)?
   (a) WIP arising under construction contracts
   (b) Raw materials
   (c) Shares
   (d) Debentures held as stock in trade.

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
   (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).

3. All of the following costs are excluded while computing value of inventories except?
   (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)

4. Identify the statement(s) which is/are incorrect.
   (a) A storage cost which is a necessary part of the production process is included 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.

5. The cost of inventories of items that are not ordinarily inter-changeable and goods or services produced and segregated for specific projects should be assigned by
   a) Specific identification of their individual costs
   b) FIFO
   c) Weighted average cost formula
   d) (b) or (c)

6. Inventory consists of
   a) Raw materials and consumables and loose tools
   b) Work in process
   c) Finished goods
   d) All of the above

7. Which of the method is not recommended by AS 2?
(a) FIFO
(b) LIFO
(c) Weighted average
(d) Specific identification method

8. Inventory account should be classified in which section of a balance sheet?
(a) Current assets
(b) Investments
(c) Property, plant, and equipment
(d) Intangible assets

ANSWERS	1	2	3	4	5	6	7	8
	b	a	b	b	a	d	b	a

9. MCQ's Created by Jai Sir and Team

9. X Co. Limited purchased goods at the cost of ₹ 40 lakhs in October, 20X1. Till March, 20X2, 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. Advice, what is the correct closing stock to be disclosed as at 31.3.20X2.
a) ₹ 10 lakhs
b) ₹ 11 Lakhs
c) ₹ 9.9 Lakhs
d) ₹ 9 Lakhs

10. What will be the value per kg of finished goods which consisting of:

	₹ Per kg.
Material cost	200
Direct labor	40
Direct variable overhead	20

Fixed production charges for the year on normal working capacity of 2 lakh kgs is ₹ 20 lakhs. 4,000 kgs of finished goods are in stock at the year end.
a) ₹ 1,04,000
b) ₹ 10,80,000
c) ₹ 270
d) ₹ 10,04,000

11. A trader purchased certain articles for ₹ 85,000. He sold some of articles for ₹ 1,05,000. The average percentage of gross markup is 25% on cost. Opening stock of inventory at cost was ₹ 15,000. Cost of closing inventory is:

(a) ₹ 20,000
(b) ₹ 5,000
(c) ₹ 25,000
(d) ₹ 16,000

12. When valuing inventories at the lower of cost and net realizable value, which underlying principle is primarily being upheld?

a) Prioritizing the historical purchase price over future market dynamics.
b) Ensuring that assets maintain a consistent valuation irrespective of market fluctuations.
c) Recognizing that no asset should be carried at a value exceeding what can be realized through its sale or utilization, considering factors such as estimated selling price, costs of completion, and costs to make the sale.
d) Emphasizing the importance of periodic inventory counts over value considerations.

13. Company DEF operates in a competitive market environment. During a specific accounting period, they incurred various costs related to their production and distribution processes. The details are as follows:

Direct Materials Cost: ₹ 12,500, including ₹ 1,500 for materials wasted due to unforeseen technical issues.

Direct Labour Cost: ₹ 9,000, of which ₹ 1,000 was spent on overtime due to increased demand.

Factory Overhead: ₹ 7,500, with ₹ 500 attributed to a machine repair that was more than budgeted.

Storage Costs: ₹ 2,500, out of which only ₹ 2,000 related to production.

Administrative Overheads: ₹ 5,500, including ₹ 1,000 for an advertising campaign to promote the product, which did not directly affect the inventory's condition or location.

Selling and Distribution Costs: ₹ 4,000, with ₹ 700 spent on expedited shipping due to customer-specific requirements.

Given the principles of inventory costing, how much of the above costs should be excluded when determining the cost of inventories?

(a) ₹ 3,500
(b) ₹ 8,700
(c) ₹ 5,200
(d) ₹ 6,200

14. When considering the cost components that can be included in the valuation of inventory, which of the following statements align with standard practices?

(a) All costs incurred by a company, regardless of their nature, are directly added to the inventory valuation.

(b) Interest and borrowing costs are universally excluded from inventory costs unless the inventory requires a significant period to be prepared for sale, as seen with products like wine.
(c) Amortization of intangibles, such as copyrights for publishers, is explicitly recognized and always included in the determination of inventory costs.
(d) Exchange differences, regardless of their magnitude, are always incorporated into the inventory cost calculations.

15. In determining estimates of net realizable value for inventories after the balance sheet date, which of the following statements is most accurate?
(a) Estimates of net realizable value solely depend on the initial purchase cost of the inventory.
(b) Estimates are static and do not consider any events occurring after the balance sheet date.
(c) Estimates consider fluctuations in price or cost post-balance sheet, but only if such events alter the conditions existing at the balance sheet date.
(d) Fluctuations in price or cost after the balance sheet date are always excluded from the estimation process.

16. Company STU maintains detailed records of its inventories. During a review, they found varying costs and potential net realizable values (NRVs) for different items. Given the principle they follow, how should Company STU ideally compare the cost with the net realizable value for their inventory?
(a) Aggregate all inventory items and compare the total cost against the total NRV.
(b) Compare the cost and NRV for each item individually without any grouping.
(c) Group items only if they have identical costs and compare the grouped total against the NRV.
(d) Group similar or related items for comparison purposes, but ensure that each comparison is made on an item-by-item basis within those groups.

17. Company DEF operates in a competitive market environment. During a specific accounting period, they incurred various costs related to their production and distribution processes. The details are as follows:
Direct Materials Cost: ₹ 12,500, including ₹ 1,500 for materials wasted due to unforeseen technical issues.
Direct Labour Cost: ₹ 9,000, of which ₹ 1,000 was spent on overtime due to increased demand.
Factory Overhead: ₹ 7,500.
Storage Costs: ₹ 2,500, out of which only ₹ 2,000 related to production.
Administrative Overheads: ₹ 5,500, including ₹ 1,000 for transport cost of bringing the inventory into warehouse.
Selling and Distribution Costs: ₹ 4,000, with ₹ 700 spent on shipping due to customer-specific requirements.
Given the principles of inventory costing, how much of the above costs should be Included when determining the cost of inventories?
(a) ₹ 34,000

(b) ₹ 30,500
(c) ₹ 34,700
(d) ₹ 29,500

18. Consider the following information, Calculate the Cost of Inventory:

- Purchase Cost: Rs. 50,000
- Non-refundable Duties and Taxes: Rs.5,000
- Freight: Rs.3,000
- Conversion Costs (Labor cost): Rs.12,000
- Other Costs of bringing inventory to its location and condition: Rs.8,000
- Abnormal Losses: Rs.2,000
- General Overheads: Rs.7,000
- Godown Rent: Rs.4,000
- Trade Discount: Rs.6,000
- Borrowing Cost: Rs.1,500 (Inventory takes 1 month for ready to sale)
- Total Fixed Production Overheads: Rs.10,000, normal capacity is 2000 units and actual production 1800 units.
- Variable Production Overheads (absorbed based on actual capacity): Rs.15 per hour (consider 500 hours of actual capacity)

a) Rs. 91,000
b) Rs. 89,500
c) Rs. 88,500
d) Rs. 92,500

19. Gamma Ltd. has inventory of raw material Y of 10,000 units as at 31 March, 20X4 with a carrying amount of Rs. 100 each. The current market value of that raw material is Rs. 95 each. Gamma Ltd. will use the raw material to manufacture a component for a customer. The conversion cost for making the finished goods would be Rs. 130 each. Gamma Ltd. estimates costs to completion and sale of Rs. 50 each and a selling price for the component is estimated to be Rs. 290 each.
At what value the raw material Y be measured in the books of Gamma Ltd. as per applicable IndAS?
(a) Rs. 950 thousand
(b) Rs. 1100 thousand
(c) Rs. 1600 thousand
(d) Rs. 1000 thousand

Explanations:

Q11.

Sale value of Opening stock and purchases = (85,000 + 15,000) x 1.25 = 1,25,000

Sales = 1,05,000

Sale value of unsold stock = (1,25,000 - 1,05,000) = 20,000

Less gross mark up = 4,000

Hence, Closing stock = **16,000 (d)**

Q13.

In determining the cost of inventories in accordance with paragraph 6, it is appropriate to exclude certain costs and recognise them as expenses in the period in which they are incurred.

Examples of such costs are:

(a) abnormal amounts 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.

Hence answer is = (1,500 + 1,000 + (2,500 - 2,000) + 1,000 + 4,700) = **8,700 (b)**

Q17.

In determining the cost of inventories in accordance with paragraph 6, it is appropriate to exclude certain costs and recognise them as expenses in the period in which they are incurred.

Examples of such costs are:

(a) abnormal amounts 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.

Hence answer is = 11,000 + 9,000 + 7,500 + 2,000 + 1,000 = **30,500 (b)**

Q18

50,000 + 5,000 + 3,000 + 12,000 + 8,000 – 6,000 + 9,000 fixed oh + 7,500 = **88,500**

Q19

As per AS 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 sold at or above cost. However, when a decline in the price of materials indicates that the cost of the finished products exceeds net realisable value, the materials are written down to net realisable value. In such circumstances, the replacement cost of the materials may be the best available measure of their net realisable value. Here, the NRV of each unit of finished goods is Rs. 240 (ie Rs. 290 – Rs. 50), which is more than the cost of finished goods ie Rs. 230 (ie. Rs. 100 + Rs. 130). Hence the raw material will be valued at cost ie Rs. 100 each. Thus, the total cost of raw material will be Rs. 10,00,000 (ie Rs. 10,000 x Rs. 100)

ANSWERS	9	10	11	12	13	14	15	16	17	18	19
	c	c	d	c	b	c	c	d	b	c	d

CA NOTES COMMUNITY NETWORK

Click on Icon	QR CODE	LINK
Join what's App group		CLICK HERE
Join Telegram Channel		CLICK HERE
Subscribe On Youtube		CLICK HERE
Follow us On Instagram		CLICK HERE

BE A PART OF CNC FAMILY

CNC – CA NOTES COMMUNITY

Mail at (for complaints/feedback) – canotescommunity@gmai.com

THANK YOU TEAM CNC

4

ACCOUNTING STANDARD – 10
PROPERTY, PLANT & EQUIPMENT

"Push yourself, because no one else is going to do it for you"

1. IMPORTANT DEFINITIONS

1. PROPERTY PLANT AND EQUIPMENT

Any Tangible item will be called as PPE if it satisfies the following Conditions:

Condition – 1	Condition – 2
Held for Use in • Production or Supply of goods and services • For Rental to Others • For Administrative Purposes	Expected to be Used for more than 12 Months.
Renting should be the main business activity of the entity to Qualify tangible item as PPE otherwise it would be qualified as an Investment Property under AS 13	

2. BIOLOGICAL ASSETS

It means Living Plants and Animals. AS 10 doesn't apply to Biological Assets except on Bearer Plants.

3. BEARER PLANT:

a plant that satisfies all the 3 conditions:

Bearer Plant is a plant which	is used in the production or supply of Agricultural produce
	is expected to bear produce for more than a period of 12 months
	Has a remote likelihood of being sold as Agricultural produce Except for incidental scrap sales

Note: When bearer plants are no longer used to bear produce, they might be cut down and sold as scrap. For example - use as firewood. Such incidental scrap sales would not prevent the plant from satisfying the definition of a Bearer Plant.

Example of bearer plant is Mango Tree, Coconut Tree etc

2. RECOGNITION CRITERIA FOR PPE

The cost of an item of PPE should 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 enterprise, and

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

Treatment of Spare Parts, Standby Equipment and Servicing Equipment
Case I: If they meet the definition of PPE as per IND AS 16: Recognised as PPE as per IND AS 16
Case II: If they do not meet the definition of PPE as per IND AS 16: Such items are classified as Inventory as per IND AS 2. • Treat Expense First as a part of Purchase of Goods • if at the end of Reporting Period, these items are not yet fully consumed then treat them as Inventory (Closing Stock)

3. MEASUREMENT OF PPE

At Initial Recognition	Subsequent measurement on BS date
	COST MODEL
COST MODEL	(Or)
	REVALUATION MODEL

Note: Selection of Any Model at BS date is an Accounting Policy.

INITIAL RECOGNITION

Cost of an item of PPE comprises:

COST Includes	COST Excludes
(a) Purchase Price including Import duties and Non-refundable Taxes (b) Any Directly attributable Costs bringing the Asset to its 'location and condition' Eg. • Cost of Employee benefits on construction or acquisition of PPE • Installation Cost • Cost of Testing the PPE	• Cost of Opening new business such as inauguration cost • Startup Costs (i.e. Legal Expenses) • Cost of introducing a new product including advertising • Initial operating losses

• Professional Fees • Initial delivery Cost etc **(c) Decommissioning Restoration and Similar Liabilities** This cost is to be estimated using appropriate discounting rate i.e. it should be recognised initially at PV of future outflow.	• Cost of relocating or reorganizing part or all the operations of an enterprises. • Administrative and other general overheads • Abnormal Cost/Losses (eg. Loss due to strike) • Staff Training Costs • Income earned from incidental operations eg. Income from Car Park.
Excess of Net Proceeds from Sale of Items produced during testing will be deducted from the Cost of Item of PPE.	

Example 1:

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

ANSWER:

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

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

Example 2:

1/4/23, PPE Purchased @3 Crore, DAC is 1 Crore, Life of PPE = 10 Years.

There is a Decommissioning Liability after 10 Years of Rs. 25 lakhs. Discount Rate is 10% p.a.

What is the cost of PPE? & How to treat Decommissioning Liability.

Solution:

Purchase	3,00,00,000
+ DAC	1,00,00,000
+ PV of Decommissioning Liability	9,63,858
Cost of PPE	**4,09,63,858**

1/4/23	PPE A/c Dr. To Bank A/c To Decommissioning Liability A/c	4,09,63,858	 4,00,00,000 9,63,858
31/3/24	Interest Cost A/c Dr. To Decommissioning Liability A/c	96,386	 96,386

4. MEASUREMENT OF COST AT INITIAL RECOGNITION:

Case - 1

If Payment is deferred beyond Normal Credit Terms:

Cost of an item of PPE is the CASH PRICE EQUIVALENT (Present Value of Agreed Price) at the recognition date:

Total Contract Value (-) Present Value of Future Cash Outflow (discounting)	XXX XXX
Interest Cost (Charged to P&L)	XXX

Example 3: - (Payment is beyond normal Credit Term)

Asset is Purchased & Payment will be made after 1 Year of ₹ 80,00,000. Discount Rate is 7% p.a.

Pass necessary Journal Entry

Solution:

PV of 80lakhs @7% p.a. = 80,00,000 / 1.07 = 74,76,635

Date of Purchase	Asset A/c Dr. To Creditor A/c	74,76,635	 74,76,635
Date of Payment	Creditor A/c Dr. Interest A/c Dr. To Bank A/c	74,76,635 5,23,365	 80,00,000

Example 4: - (Payment is Beyond Normal Credit Term)

Asset is Purchased & Payment will be made equally in 2 installments of 80,00,000 in 2 years. Discount Rate is 7% p.a.

Pass necessary Journal Entry.

Solution:

Cost of Asset is equal to "Cash Price Equivalent".

Cash Price Equivalent mean PV of 40,00,000 @7% Discount for 2 Years.

Year	Amount	PVF	PV
1	40,00,000	0.935	37,40,000

2	40,00,000	0.873	34,92,000
Cost = Cash Price Equivalent			72,32,000

Date of Purchase:

Asset A/c Dr. To Creditor A/c	72,32,000	 72,32,000

1^{st} Year End:

Interest A/c Dr. To Creditor A/c	5,06,240	 5,06,240
Creditors A/c Dr. To Bank A/c	40,00,000	 40,00,000

Creditor A/c

To Bank A/c	40,00,000	By Asset A/c	72,32,000
To Balance C/d	37,38,240	By Interest A/c	5,06,240

2^{nd} Year:

Interest A/c Dr. To Creditor A/c	2,61,760	 2,61,760
Creditors A/c Dr. To Bank A/c	40,00,000	 40,00,000

Case - 2

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

Cost of such an item of PPE is measured at fair value of Asset Given Up (1^{st} Priority) or Asset Received (2^{nd} Priority) unless:

(i) Exchange transaction lacks commercial substance; Or

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

If the PPE acquired is not measured at Fair Value, its cost is measured at the carrying amount of the asset given up.

Example 5:

Fair value of Asset Purchased Rs. 1,00,000/-

Fair Value of Asset Given up Rs. 70000/-

Cash Paid Rs. 25000/-

Carrying Amount of Given up asset Rs. 55000/-

How to Record Asset Purchased, assume Commercial substance is present in the transaction.

Solution:

New Asset A/c Dr.	95000	
To Old Asset A/c		55000
To Bank A/c		25000

To Gain (P&L) 15000 (B/f)

Example 6:

Fair value of Asset Purchased Rs. 3,00,000/-Fair Value of Asset given up is not known Carrying Amount of Given up asset Rs. 5,50,000/-Cash Received - 200000

How to record as per IndAs 16, Assume Commercial substance is present in the transaction.

Solution:

New Asset A/c	Dr.	3,00,000	
Bank A/c	Dr.	2,00,000	
Loss on Ex.	Dr.	50,000	
To Old Asset A/c			5,50,000

Example 7:

Fair value of Asset Purchased Rs. 3,00,000/-

Fair Value of Asset given up 3,30,000/-

Carrying Amount of Given up asset Rs. 2,00,000/-

Cash Paid 50,000/-

Give Accounting Treatment as per IndAs 16,

Assuming No Commercial substance is present in the transaction.

Solution

New Asset A/c	Dr.	2,50,000 (B/f)	
To Old Asset A/c			2,00,000
To Cash A/c			50,000

Case - 3

PPE purchased for a Consolidated Price:

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

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

Case - 4

Government Grant related to PPE:

If Govt. Grant is received in Kind (i.e. PPE received at Free of Cost) then it should be recognised at Nominal Value as per AS 12.

5. MEASUREMENT OF PPE AT BALANCE SHEET DATE

An enterprise should choose,

- Either Cost model,
- Or Revaluation model

as its accounting policy (IND AS 8) and should apply that policy to an entire class of PPE.
Any change in Accounting Policy shall have Retrospective effect.

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

Examples of separate classes:

1) Land
2) Land and Buildings
3) Machinery
4) Ships
5) Aircraft
6) Motor Vehicles
7) Furniture and Fixtures
8) Office Equipment
9) Bearer plants

Example 8:
Venus Ltd. is a large manufacturing group. It owns a considerable number of industrial buildings, such as factories and warehouses, and office buildings in several capital cities. The industrial buildings are located in industrial zones whereas the office buildings are in central business districts of the cities. Venus's Ltd. management wants to apply the Ind AS 16 revaluation model to subsequent measurement of the office buildings but continue to apply the historical cost model to the industrial buildings. Is this acceptable under Ind AS 16, Property, Plant and Equipment?

SOLUTION:
Venus's Ltd. management can apply the revaluation model only to the office buildings. The office buildings can be clearly distinguished from the industrial buildings in terms of their function, their nature and their general location. Ind AS 16 permits assets to be revalued on a class-by-class basis. The different characteristics of the buildings enable them to be classified as different PPE classes.

Cost Model
After recognition as an asset, an item of PPE should be carried at:
Cost - Any Accumulated Depreciation - Any Accumulated Impairment losses

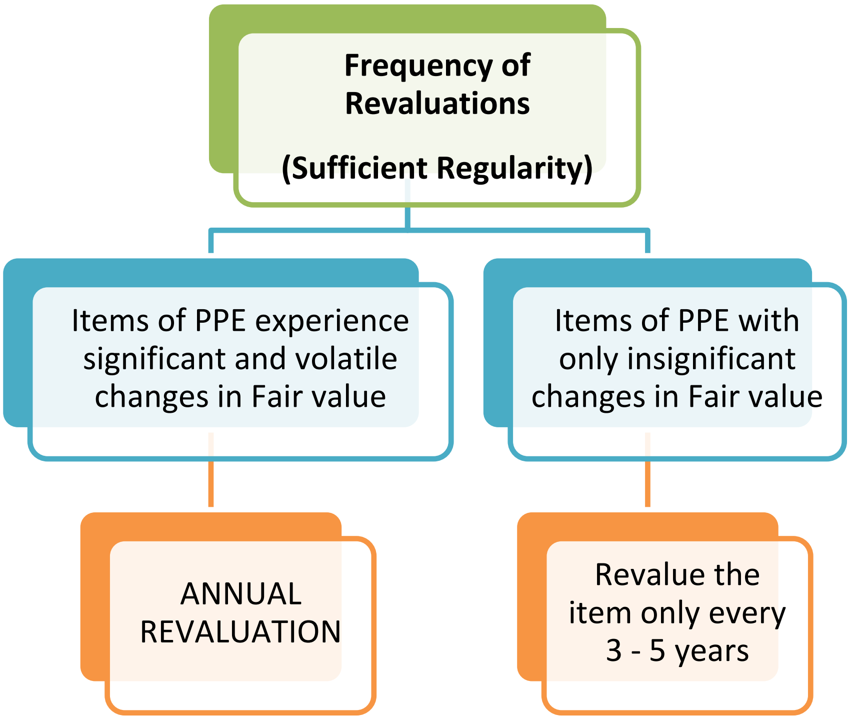
Revaluation Model

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

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

Revaluation for entire class of PPE

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



6. ACCOUNTING TREATMENT OF REVALUATIONS

When an item of PPE is revalued, the carrying amount of that asset is adjusted to the revalued amount. At the date of the revaluation, the asset is treated in one of the following ways:

Technique 1:
Accumulated depreciation is eliminated against the gross carrying amount of the asset

Step 1 – Eliminate the Accumulated Depreciation balance from Gross Carrying amount of PPE (Debit Acc. Dep A/c and Credit PPE A/c)

Step 2 – Now Compare the Net Carrying Amount of PPE with Fair Value of PPE and determine the Revaluation Profit/Loss

Step 3 – Increase or Decrease the Net Carrying Amt. of PPE with the Revaluation Profit/Loss by either Debiting or Crediting the PPE.

Technique 2:
Restatement Approach (No elimination of Accumulated Depreciation)

Gross carrying amount and Accumulated Depreciation is adjusted in a manner that is consistent with the revaluation of the carrying amount of the asset.

- No need to eliminate Accumulated Depreciation.
- Calculate the Revaluation Gain/Loss and its "% of Change" (Gain (loss) / WDV)
- Increase/Decrease the Original Cost and Accumulated Depreciation with above % and pass following journal entry:

PPE A/c Dr.
  To Accumulated Depreciation A/c
  To Revaluation Surplus A/c

Example 9:

Jupiter Ltd. has an item of plant with an initial cost of Rs. 100,000. At the date of revaluation accumulated depreciation amounted to Rs. 55,000. The fair value of asset, by reference to transactions in similar assets, is assessed to be Rs. 65,000. Find out the entries to be passed?

SOLUTION:

Method – I: Accumulated Depreciation is eliminated

Accumulated depreciation	Dr.	55,000	
To Asset Cost			55,000
Asset Cost	Dr.	20,000	
To Revaluation reserve			20,000

The net result is that the asset has a carrying amount of ₹ 65,000 (100,000 – 55,000 + 20,000).

Method – II: Change in gross carrying amount and accumulated depreciation

Carrying amount (100,000 – 55,000)	45,000
Fair value (revalued amount)	65,000
Surplus	20,000
% of surplus (20,000/ 45,000)	44.44%

Entry to be Made:

Asset (1,00,000 x 44.44%)	Dr.	44,444	
To Accumulated Depreciation (55,000 x 44.44%)			24,444
To Surplus on Revaluation			20,000

(6.1) Revaluation - Increase or Decrease – Treatment

1) Increase in value of PPE:

General Rule	Increase is credited to Revaluation Reserve
Exception: Subsequent Increase, earlier PPE value was decreased	Increase in value shall be first charged to P&L to the extent of earlier reduction, remaining increased value is credited to Revaluation Reserve

2) Decrease in value of PPE:

General Rule	Decrease is debited to Profit and Loss A/c
Exception: Subsequent Decrease, earlier PPE value was increased	Decrease in value shall be first charged to Revaluation Reserve to the extent of balance of RR available, remaining decreased value is debited to Profit and Loss

Example 10:

Upward revaluation and further Downward: -

31.03.2010 Carrying amount 500000

31.03.2010 Fair Value 650000

31.03.2011 Fair Value Case 1 - 550000 and Case 2 - 450000

Pass Journals.

Solution:

Case 1:

31.03.2010

PPE a/c	Dr.	150000	
To Revaluation Reserve			150000

31.03.2011

Revaluation Reserve	Dr.	100000	

To PPE 100000

Case 2:

31.03.2010

PPE a/c Dr. 150000

To Revaluation Reserve 150000

31.03.2011

Revaluation Reserve Dr. 150000

P/L a/c Dr. 50000

To PPE 200000

(6.2) Utilisation of Revaluation Surplus

The revaluation surplus included in owners' interests in respect of an item of PPE maybe transferred to the Revenue Reserves (i.e. Retained Earnings) when the asset is de-recognised.

Case I: Mandatory transfer of Revaluation Reserve to Retained Earnings (GR):

When the asset is:

- Retired; or
- Disposed of

Case II: Option to Transfer Revaluation Reserve to Retained Earnings (GR)

- When the asset is still used by an enterprise not yet sold.
- Transfer the amount equal to the excess depreciation due to Upward Revaluation.

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

Example 11:
On 01/04/21, PPE Purchased at a cost of 10,00,000 with useful life of 10 Years. Depreciation is chargeable on SLM basis. On 01/04/23, Fair Value of PPE is 9,50,000.

7. TREATMENT OF DIFFERENT SUBSEQUENT EXPENDITURE ON PPE

1. **Cost of day to day Servicing:** This cost is directly recognised in the Statement of Profit and Loss because it does not increase the earning efficiency of PPE.

2. **Replacement of parts of PPE:** Capitalise in the carrying amount of PPE if the recognition criteria are met. (i.e. Future Economic Benefits + Cost Reliable)

Examples:
a) Aircraft interiors such as seats and galleys may require replacement several times during the life of the air frame.
b) Replacing the interior walls of a building, or to make a non-recurring replacement.

3. **Regular Major Inspection or Overhaul:** When each major inspection is performed, its cost is recognised in the carrying amount of the item of PPE as a replacement, if the recognition criteria are satisfied.
Any remaining carrying amount of the cost of the previous inspection (as distinct from physical parts) is derecognized.

Example 12:
A shipping company is required by law to bring all ships into dry dock every five years for a major inspection and overhaul. Overhaul expenditure might at first sight seem to be a repair to the ships but it is actually a cost incurred in getting the ship back into a seaworthy condition. As such the costs must be capitalised.
A ship which cost ₹ 20 million with a 20 year life must have major overhaul in every five years. The estimated cost of the overhaul at the five-year point is ₹ 5 million.
The depreciation charge for the first five years of the assets life will be as follows:

	Overhaul Component (Million)	Ship (other than overhaul component) Million
Cost	5	15
Years	5	20
Depreciation per year	1	0.75

Total accumulated depreciation for the first five years will be Rs. 8.75, and the carrying amount of the ship at the end of year 5 will be Rs. 11.25 million.
The actual overhaul costs incurred at the end of year 5 are Rs. 6 million. This amount will now be capitalised into the costs of the ship, to give a carrying amount of Rs. 17.25 million.
The depreciation charge for years 6 to 10 will be as follows:

	Overhaul Component (Million)	Ship (other than overhaul component) Million
Cost	6	11.25

Years	5	15
Depreciation per year	1.2	0.75

Annual depreciation for years 6 to 10 will now be Rs.1.95 million. This process will be continued for years 11 to 15 and years 16 to 20. By the end of year 20, the capital cost of ₹ 20 million will have been depreciated plus the actual overhaul costs incurred at years 5, 10 and 15.

8. DEPRECIATION

Component Method of Depreciation:

Each part of an item of PPE with a cost that is significant in relation to the total cost of the item with significant useful life different from other components should be depreciated separately.

Example 13:

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

Is Grouping of Components possible?

Yes.

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

(a) Accounting Treatment:

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

- **AS 2:** Depreciation of manufacturing plant and equipment is included in the costs of conversion of inventories.
- **AS 26:** Depreciation of PPE used for development activities may be included in the cost of an intangible asset.
- **AS 10:** Depreciation of PPE used for construction and development of another self- generated PPE may be included in the cost of self-generated asset.

(b) Depreciable Amount and Depreciation Period

What is "Depreciable Amount"?

Depreciable amount is:

Cost of an asset (or other amount substituted for cost i.e. revalued amount) - Residual value

The depreciable amount of an asset should be allocated on a systematic basis over its useful life.

(c) Review of Residual Value and Useful Life of an Asset

Residual value and the useful life of an asset should be reviewed at least at each financial year-end and, if expectations differ from previous estimates, the change(s) should be accounted for as a change in an accounting estimate in accordance with AS 5.

(d) Commencement of period for charging Depreciation

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

Depreciation in Case the asset is Not Working/ lying idle (in case of situations like covid):
Depreciation of an asset ceases, at the earlier of the date that ,the asset is classified as held for sale and the date the asset is de-recognised. Therefore, the asset continues to be depreciated even if it remains idle, unless the asset is fully depreciated.

Apart from the above, it may be noted that as per AS 10, one of the factors in determining useful life of an asset is technical or commercial obsolescence. Therefore, even when the asset is idle, the same should be depreciated due to technical or commercial obsolescence and wear and tear during that period.

(e) Cessation of Depreciation

I. Depreciation ceases to be charged when asset's residual value exceeds its carrying amount; or

II. Depreciation of an asset ceases at the earlier of:

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

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

(f) Depreciation of Land and Buildings

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

A. **Land:** Land has an unlimited useful life and therefore is not depreciated.
Exceptions: Quarries and sites used for landfill.
Depreciation on Land:
I. **If land itself has a limited useful life:**
It is depreciated in a manner that reflects the benefits to be derived from it.
II. If the cost of land includes the costs of site dismantlement, removal and restoration:
That **portion of the land asset** is depreciated over the period of benefits obtained by incurring those costs.

B. **Buildings:**
Buildings have a limited useful life and therefore are depreciable assets.
An increase in the value of the land on which a building stands does not affect the determination of the depreciable amount of the building.

(g) Depreciation Method

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

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

- There is a **change in the expected pattern of consumption of** those future economic benefits; or
- That the method is changed in accordance with the statute to best reflect the way the asset is consumed.

(h) Review of Depreciation method:

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

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

9. RETIREMENTS

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

- Carrying Amount, and
- Net Realisable Value

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

10. DE-RECOGNITION

The carrying amount of an item of PPE should be de-recognised:

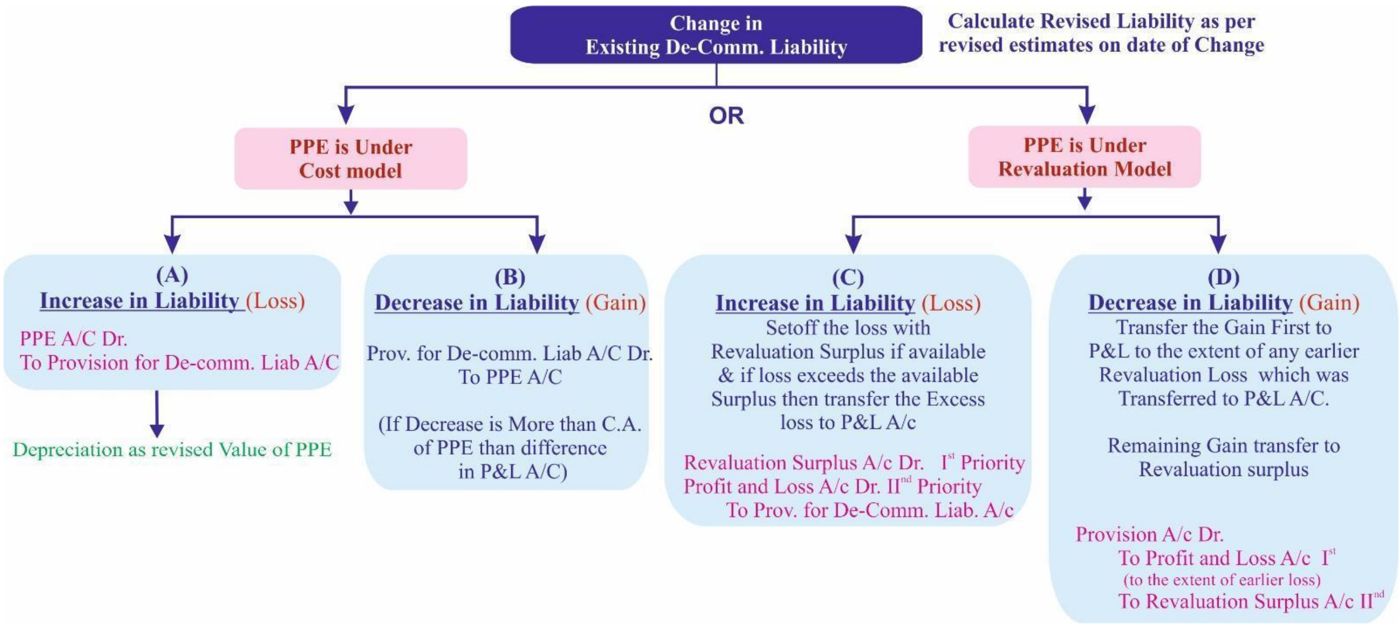
- On disposal
- By sale
- By entering into a finance lease, or
- By donation, or
- When no future economic benefits are expected from its use or disposal

Accounting Treatment:

- Gain or loss arising from de-recognition of an item of PPE should be included in the Statement of Profit and Loss when the item is derecognized.
- Compensation from third parties for items of PPE that were Impaired, Lost or Given up shall be included in Profit and Loss when such compensation becomes receivable.

- Gain or loss arising from de-recognition of an item of PPE =
  Net disposal proceeds (if any) - Carrying Amount of the item

11. CHANGES IN EXISTING DECOMMISSIONING, RESTORATION AND OTHER LIABILITIES



Example 14:

PPE costs Rs. 50 Lacs acquired on 01.04.21 with estimated useful life of 20 years. Estimated Decommissioning liability to be incurred after 20 years is 12 Lacs. Discounting Rate is 10%. At the end of the 6th Year, estimated outflow of Decomm. Liab. Changed to Rs. 10 Lacs & discounting rate changed to 11%.

Apply IndAS 16 till 6th Year.

Solution

1. Calculate total cost of PPE as on 1/4/21

Particular	Amount
Purchase & Direct Cost	50,00,000
+ PV of Decommissioning liability (12,00,000 x 0.148)	1,78,320
Cost of PPE	**51,78,320**

Journal Entry

PPE a/c	Dr.	51,78,320	
To Bank/Creditor			50,00,000
To Provision for Decommissioning cost			1,78,320

2. Calculate the amt of provision to be shown at the end of the year under b/s

1st year. Interest cost on 178320 @ 10% = 17,832

Interest cost (P&I) Dr. 17,832
To Provision a/c 17,832

Year	Opening Balance	Interest During the year	Closing Balance
1st year	1,78,320	17,832	1,96,152
2nd year	1,96,152	19,615	2,15,767
3rd year	2,15,767	21,577	2,37,344
4th year	2,37,344	23,734	2,61,078
5th year	2,61,078	26,108	2,87,186
6th year	2,87,186	28,718	3,15,905

Carrying amount = Provision for decommissioning cost at the end of the 6th year = 3,15,905

3. Calculate the change in provision of Decommissioning cost as on 1/4/27: -

What should be the provision amt based as following received figures: -

Discount rate = 11%
Out flow = 10,00,000
Remaining period = 20 – 6 = 14 years
PVF @ 11% for 14th year = 0.232

Revised provision based as change (0.232 x 10,00,000) = 2,32,000 as on 1/4/27
Carrying amount (opening balance) of provision = 3,15,905 as on 1/4/27
Decrease in liabilities = 83,905

Case 1: Suppose PPE is under Cost model:

Provision a/c Dr. 83905
To PPE a/c 83905

Case 2: Suppose PPE is under Revaluation model:

Provision a/c Dr. 83905
To Rev. Surplus a/c 83905

However, gain to the Extent of earlier Revaluation loss shall be charged to P&I a/c.

12. MCQ's from ICAI Resources

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
   (b) Costs of site preparation
   (c) Costs of relocating
   (d) Installation and assembly costs.
   (e) initial delivery and handling costs

2. As per AS 10 (Revised) 'Property, Plant and Equipment', an enterprise holding investment properties should value Investment property
   (a) As per fair value
   (b) Under discounted cash flow model.
   (c) Under cost model
   (d) under cash flow model

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?
   (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.

4. A plot of land with carrying amount of 1,00,000 was revalued to 90,000 at the end of Year. 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?
   (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.

5. On sale of an asset which was revalued upwards, what would be the treatment of Revaluation Reserve?

(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

(d) The Revaluation Reserve is reduced from the asset value to compute profit or loss.

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

(a) ₹ 10,000

(b) ₹ 11,800.

(c) ₹ 9,000

(d) ₹ 10,500.

ANSWERS	1	2	3	4	5	6
	B	C	C	C	B	A

13. MCQ's Created by Jai Sir and Team

7. Entity A exchanges land with a book value of Rs. 10,00,000 for cash of Rs. 20,00,000 and plant and machinery valued at Rs. 25,00,000. What will be the measurement cost of the assets received. (Consider that the transaction has commercial substance)?
   a) 10,00,000
   b) 20,00,000
   c) 45,00,000
   d) 25,00,000

8. In an exchange transaction where Entity A swaps car X (with a book value of 3,00,000 and a fair value of 3,25,000) for cash of 5,000 and car Y (with a fair value of 3,10,000), with no commercial substance, what will be the measurement cost of the assets received?
   a. 3,10,000
   b. 2,95,000
   c. 2,85,000
   d. 3,25,000

9. Entity B purchased an asset on 1st January 2021 for Rs. 1,50,000 and the asset had an estimated useful life of 8 years with no residual value. On 1st January 2026, the directors review the estimated life and decide that the asset will probably be useful for a further 5 years. If the company charges depreciation on a straight-line basis, what will be the amount of depreciation for each year starting from 2026?
   a. Rs. 18,750
   b. Rs. 22,500
   c. Rs. 11,250
   d. Rs. 30,000

10. Entity B purchased an asset on 1st April 2022 for Rs. 8,00,000 but put to use on 1st June, 2022 and the asset had an estimated useful life of 10 years with residual value of Rs. 40,000. On 1st April 2026, the directors review the estimated life and residual value and decide that the asset will probably be useful for a further 5 years with residual value of Rs. 50,000 at the end of life. If the company charges depreciation on a straight-line basis, what will be the amount of depreciation for year ending 2026-27?
   a. Rs. 91,733
   b. Rs. 1,01,733
   c. Rs. 89,200
   d. Rs. 76,000

11. Entity X maintained equipment in its books at 3,50,000. Unfortunately, these assets were damaged beyond repair. The insurance company, under a "New for Old" policy, replaced the

equipment with new machinery valued at 35,00,000. How should Entity X account for this situation?

a. Recognize both a loss in the Statement of Profit and Loss equal to the carrying value of the damaged equipment and receivable and a gain in the income statement resulting from the insurance proceeds under AS 29 (Revised)* once receipt is virtually certain.

b. Recognize a gain in the income statement equal to the difference between the cost of the new machinery and the carrying value of the damaged equipment.

c. Recognize a loss in the Statement of Profit and Loss equal to the carrying value of the damaged equipment.

d. Recognize a gain in the Statement of Profit and Loss equal to the cost of the new machinery.

12. Company X purchased a vacant plot of land with the intention of constructing a commercial building. However, due to delays in obtaining construction permits, the company decides to utilize the land as a paid parking lot until construction begins. During the interim period, the company incurs expenses related to managing the parking lot and generates income from parking fees.

Assume the following financial data for the year:

- Total expenses incurred for managing the parking lot: ₹50,000
- Total income generated from parking fees: ₹120,000

Considering the scenario described and the accounting treatment outlined in the statement, what would be the effect on the Statement of Profit and Loss?

a) Net income would increase by ₹70,000.

b) Net income would decrease by ₹50,000.

c) No effect to P&L a/c, net income to be deducted from cost of construction.

d) Net income would increase by ₹50,000.

13. An enterprise does not recognize in the carrying amount of an item of PPE the cost of

(a) Aircraft interiors require replacement several times during the life of the airframe

(b) Major parts of conveyor system

(c) Replacing the interior walls of a building

(d) Cost of small parts for day to day servicing

14. Which of the following costs will be included in the cost of PPE as per AS10

a) Inauguration cost

b) Cost of staff training

c) Administration Cost

d) Professional fees

15. An amusement park has a soft opening to the public, to trial run its attractions. Tickets are sold at a 50% discount during this period and the operating capacity is 80%. The official opening day of the amusement park is 3 months later.Management claimes that soft opening is a trial run necessary for the amusement park to be in condition capable of operating in the intended manner. Accordingly, the net operating cost should be

a) Capitalised
b) Recognised in the Profit & loss
c) Neither capitalise nor recognise in Profit & loss
d) On the discretion of management

16. V'Smart Ltd has a Ship, Aircraft and Machinery. V'smart
    a) Must choose same (Cost model or revaluation model) model for all Ship, aircraft and machinery
    b) Must choose same(cost model or revaluation model) model for Ship and aircraft and can choose different model for machinery
    c) Can choose different models for ship, aircraft and machinery
    d) None of the above

17. Select the most appropriate option. Each part of an item of PPE with a cost that is significant in relation to the total cost of the item should be depreciated separately in _______________ method of depreciation
    (a) Straight line method
    (b) Written down value method
    (c) Component method
    (d) None of the above

18. Depriciation of manufacturing plant and equipment is
    a. Included in the cost of conversion of inventories as per AS 2
    b. Charged to the Profit & Loss
    c. Either (a) or (b)
    d. None of the above

19. Depriciation of an asset ceases when
    a) The asset becomes idle
    b) The asset is retired from active use but not held for disposal
    c) The asset is derecognized
    d) All of the above

20. Change in Depreciation method is a
    a) Change in accounting policy
    b) Change in Accounting estimate
    c) Extraordinary Activity
    d) Change in Prior period item

21. Entity has a machine named which has carrying amount of Rs 1,00,000 using the cost model. There is a change in decommissioning liability which results in Decrease in Liability by Rs 1,05,000. Select the correct treatment.

a) The machine should be remeasured at Nil value and Rs 5,000 should be recognized immediately in the Profit & Loss account

b) The machine should be carried at Rs 1,00,000 and Rs 1,05,000 should be recognized immediately in the Profit & Loss account.

c) The machine should be remeasured at Nil value and Rs 5,000 should be recognized over the useful life of machine in the Profit & Loss account

d) The machine should be carried at Rs 1,00,000 and Rs 1,05,000 should be recognized over the useful life of the machine in the Profit & Loss account.

Correct Answer						
Q7	Q8	Q9	Q10	Q11	Q12	Q13
d	b	c	c	a	a	d
Q14	Q15	Q16	Q17	Q18	Q19	Q20
d	b	c	c	a	c	b
Q21						
a						

Explanation of Q15:

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

Student Notes:-

5 ACCOUNTING STANDARD 13
ACCOUNTING FOR INVESTMENT

"Develop success from failures. Discouragement and failure are two of the surest steppingstones to success."

1. NON-APPLICABILITY OF AS 13

AS 13 - Accounting for Investments doesn't deal with the following:

- Treatment of Income from Investments such as Dividend, Rent and Interest. These are covered under AS 9.
- Finance or Operating Leases of any Investment Property which are covered by AS 19
- Investments in Retirement benefit plans which is covered by AS 15 (in the name of Plan Assets)
- The following which is formed under the Central or the State Government Act or declared under Companies Act, 2013
    1. Mutual Funds Companies
    2. Venture Capital Funds and related Asset Management Companies
    3. Banks as well as public financial institutions

2. MEANING OF INVESTMENT AND ITS CLASSIFICATION

Investments Means: Assets held by an enterprise for:

- Earning incomes by way of dividends, interest, and rentals, or
- for capital appreciation, or
- for both.

Examples of Types of Investments:
1. Investment Shares, debentures and Bonds (including Mutual Funds)
2. Investment in Govt. Securities or Trust Securities
3. Investment in Properties (Land, Building or Both)

Note: AS 13 also applies to the Investment in Shares, Debentures and other Securities held as stock in trade with limited exceptions.

Classification of Investments as per AS 13:

1) **Current Investments** – Current Investments are investments which by their nature are readily realizable and are intended to be held for not more than one year from the date when such investment is made.
   (**Note:** The intention to hold for not more than one year is to be judged at the time of purchase of investment.)
2) **Long-Term Investments** – Long-term investments are investments other than the current investments, even though they might be freely marketable.

3. COST OF INVESTMENTS

Calculation of Cost of Investments:

Purchase Cost (Actual Amount paid) (+) Brokerage, duties and Fees	XXX XXX
Total Cost of Investments	XXX

Non-cash consideration by:

1. Issuing shares: Cost will be the fair value of Securities issued.
2. any Exchange of other asset: Cost of the investment is determined by reference to the fair value of the asset given up or the fair value of the investment acquired, whichever is more clearly evident.

Calculation of Gain/Loss on sale of of Investments:

Sale Value of Investments (i.e. Market Price) (-) Brokerage, duties and Fees	XXX XXX
Net Sale Proceeds (-) Cost of Investments	XXX XXX
Gain/Loss on Sale (Transfer to P&L)	XXX

4. MEASUREMENT OF INVESTMENTS AT BALANCE SHEET DATE

CURRENT INVESTMENTS	LONG TERM INVESTMENTS
Lower of: (a) Cost; and (b) Fair Value Such measurement may be followed either individual investment wise or entire category wise. Any reduction to Fair Value is charged to Profit and Loss Account.	Long Term Investments are usually carried at COST. Such measurement shall be made individual investment wise only. But, when there's a decline, apart from temporary, in value the long-term investment, carrying amount

If Fair Value increased subsequently, the increase in value up to the original cost of investment is credited to Profit and Loss Account. (Excess portion shall be ignored)	shall be reduced for recognizing such decline and charged to Profit and Loss account. 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.

Example of Decline in Value of Long-Term Investments "other than temporary":

- Company in which investment is made "is making cash operating losses" which has resulted in reduction of its net worth.
- New regulations which have negative impact in the working of the investee.
- Significant reduction of quoted price of the investment, etc.

5. SPECIAL CASES

1) Investment Property:

Investment properties such as Land, Building or both are investments if they aren't intended to be used significantly for business operations company.

Investment Property is to be accounted for in accordance with COST Model of AS 10 i.e. Original Cost less Accumulated Depreciation and less Accumulated Impairment.

(Note: - Revaluation Model of AS 10 is not allowed for Investment Properties i.e. Land and Building)

2) Reclassification of Investments:

CURRENT reclassified to LONG TERM	LONG TERM reclassified to CURRENT
Lower of: • Cost; and • Fair Value	Lower of: • Cost; and • Carrying Amount (Book Value)

Example:

ABC Ltd. Wants to re-classify its investments in accordance with AS 13 (revised).

Decide and state on the amount of transfer, based on the following information:

(1) A portion of current investments purchased for Rs. 20 lakhs, to be reclassified as long-term investment, as a company has decided to retain them. The market value as on the date of Balance Sheet was Rs. 25 lakhs.

The market value of the investment is Rs. 25 lakhs, which is higher than its cost i.e., Rs. 20 lakhs. Therefore, the transfer to long-term investments should be carried at cost i.e., Rs. 20 lakhs.

(2) Another portion of current investments purchased for Rs. 15 lakhs, to be reclassified as long-term investments. The market value of these investments as on the date of balance sheet was Rs. 6.5 lakhs.

The market value of the investment is Rs. 6.5 lakhs, which is lower than its cost i.e., Rs. 15 lakhs. Therefore, the transfer to long-term investments should be carried in the books at the market value i.e., Rs. 6.5 lakhs. The loss of Rs. 8.5 lakhs should be charged to profit and loss account.

(3) Certain long-term investments no longer considered for holding purposes, to be reclassified as current investments. The original cost of these was Rs. 18 lakhs but had been written down to Rs 12 lakhs to recognise other than temporary decline as per AS 13 (Revised).

The book value of the investment is Rs. 12 lakhs, which is lower than its cost i.e., Rs. 18 lakhs. Here, the transfer should be at carrying amount and hence this re-classified current investment should be carried at Rs. 12 lakhs.

6. IMPORTANT RULES FOR ACCOUNTING OF INVESTMENTS

1. RULES FOR INVESTMENT IN SHARES

RULE – 1:

When Shares are purchased multiple times on different dates at different prices then we shall calculate Average Cost per share to calculate gain/loss on sale (Avg. cost is taken when FIFO is not required).

Example 1:

Infosys share bought @ 1680/- per share (50 No.) on 15th June. On 1st July, again Infosys share bought @ 1705/- per share (45 No.). On 20th July sold 20 No. @ 1685/-. On 1st August, Infosys share purchased again 30 No. @ 1690/-. On 1st September 15 No. sold @ 1700/-

Calculate gains or losses.

Solution:

PARTICULARS	WORKING	AMOUNT
Purchase on 15th June	50 No. × 1680	84,000
Purchase on 5th July	45 No. x 1705	76,725
	95 No.	**1,60,725**
W. Avg. Cost per Share	1,60,725 ÷ 95	1,69,1.84/-
Sold on 20th July (-) W. Avg. Cost **Loss**	20 No. @ 1,685 20 No. x 1,69,1.84	33,700 33,837 **137**
20th July Balance	75 No. x@1,69,1.84	1,26,888
Purchase on 1st August	30 No. x @ 1,690	50,700
	105 No.	**1,77,588**
W. Avg. cost per share	1,77,588 ÷ 105	1,69,1.31/-
Sold on 1st September (-) W. Avg. Cost Gain as sale	15 No. @ 1,69,1.31 1,700/-	25,500 25,370 130

RULE – 2:

When investor gets bonus equity shares at free of cost, the quantity of shares would get increased. However, the carrying value of investments (Book Value) will not be Increased.

While selling the shares after getting bonus, the gain/loss shall be difference between Selling Price of Share and Average cost per Share.

Example 2:

500 shares bought at 720/- per share. After some time, Investor got Bonus share in I:5. Now 250 sharers sold at 800/- per share. Find out gain on Sale.

Solution:

W.Avg. Cost = (500 x 720) + (100 x 0) = 600/- per share

Gain = (800-600) x 250 = 50,000/-

Journal Entry

1) Investment a/c Dr. 3,60,000
   To Bank a/c 3,60,000
   (Buy 500 No. @ 720/-)

2) Bonus share: No entry.

3) **Sale:** Bank a/c Dr. 2,00,000
   To Investment A/c 150000
   To Gain as sale A/c 50000

Example 3:

Investment in share:

1/4/24 = Purchased 500 No @ 45/- each

1/6/24 = Purchased 300 No @ 52/- each

1/8/24 = Got bonus share in 2:5 (free)

1/9/24 = Sold 450 No. @ 50/- each

Required: 1) Calculate gain/loss on sale

2) pass journal entries

3) Prepare Investment a/c

Answer: W. Avg. Cost = 34.02/-; Gain on Sale = 7191/-

RULE – 3:

When Investor is Eligible for Right Issue shares:

Then there are two possibilities.

1) If Investor Subscribes the Right Issue:
   a) Carrying Amount of Investment would get Increased by cost of acquisition.
   b) Quantity of Shares would also be Increased.
   c) Therefore, we need to calculate Weighted Average Cost per share after Right Issue.

OR

2) If Investors are not subscribing the Right Issue and Selling the Right:

A) GENERAL RULE: Sale Proceeds are Transferred to Profit & Loss Account

Bank A/c Dr.

To Profit & Loss Account

B) If Original shares were acquired at Cum Right Price & after the Right Issue, Market Price is Lower than above Cum Right Price (i.e., Cost) then treat the sale proceeds as recovery towards Cost and it will be Credited to Investment Account.

Bank A/c Dr.

To Investment A/c

Note: Two Conditions must be fulfilled:

1) Original Shares must have been Purchased @ Cum Right Basis.
2) Market Price per Share after the Right Issue must be lower than above Cum Right Price, (i.e., Cost of Original Shares).

Example 4:

Investor has 5000 No. Of shares whose cost is 1,25,000

After some time, Investor got Right issue offer in the ratio of 1:5 at Right issue price of 180/-

Case 1: Investor Subscribed all 1000 shares

Case 2: Investor has transferred this right to third party @ 20/- each.

Case 3: Investor Subscribed 50% Right issue & rest 50% transferred @ 20/- each.

Solution

Case 1	
Investment alc Dr. To Bank A/c (180/-x 1000 No.)	1,80,000 1,80,000
Case 2	
Bank a/c Dr. To P&L a/c	20,000 20,000
Case 3	
Investment a/c Dr. To Bank a/c (500 x 180/-)	90,000 90,000
Bank a/c Dr. To P&L a/c (500 × 20) (Sale proceeds)	10,000 10,000

Example 5:

Mr. Jai has 1200 shares of HDFC Bank Whose value is 22,80,000/- on 1/4/24

On 1/5, Jai purchased another 300 shares of HDFC @ 2,100/- each

on 1/6, Jai got Bonus Shares from HDFC in 1:5

On 1/7, Jai sold 800 shares @ 2,250/- each

on 1/8, HDFC announced Right issue in 1:2 @ Discounted price or 1,750/- each.

Mr. Jai Subscribed 60% of Right issue Offer & rest 40% transferred to third party @90/-each

Show Investment a/c (in the Books OF Mr. Jai)

Example 6:

Company announced Right issue as 1:2 at 40/- each

After announcement MP becomes 75/- (this is Cum Right Price)

Investor bought 1000 shares at 75/- each. After Right issue market price becomes:

Case a) 80/-

Case b) 60/-

Case c) 75/-

We transferred 500 no. or Right offer to Third party at 10/- each

RULE – 4:

If Annual Dividend is Declared and Paid then it must be calculated on the total no. of shares held on the date of receipt of Dividend (Except Bonus Issue and Right Issue Received in Current Year).

If Interim Dividend is Declared in current year in which Bonus & Right issue made and Dividend is Declared after Bonus and Right Issue then it shall be calculated on total share Held on the date of Dividend Including Bonus & Right.

Example 7:

Vikas holds 5,000 Shares as on 1/4/23 (FV = 10/-). On 1/5/23 Vikas purchased same shares (2,000 no.), again on 1/6/23, Vikas got 1000 no. of same shares as Bonus. On 1/7/23, Vikas got 1500 no as Right issue. On 1/8/23 Company paid Dividend @12%

How much Dividend Vikas received?

Example 8:

Taking details from the above example company paid interim dividend on 15th oct @6%

How much Dividend Vikas has received?

RULE – 5: Dividend received on Investment in Equity Shares

1) **Pre-Acquisition dividend (It is of Pre-Acquisition Period)**

Reduce Investment because it is treated as recovery of cost

Bank A/c Dr.

To Investment A/c

2) **Post-Acquisition dividend (It is of Post-Acquisition Period)**

Transfer to Profit and Loss Account

Bank A/c Dr.

To Profit & Loss A/c

Example 9:

Nikhil purchased shares of company on 1/5/23 from market @140/- per share (500 no). On 1/7/23 Nikhil received Dividend from Company @ 15% Face value is 100/-

Show journal entries in the Books of Investor (Nikhil).

Answer: Pre-acquisition Dividend = 7,500 to be deducted from cost of investment.

Example 10:

From the above example, Nikhil again received dividend on 1/7/24 @20%.

RULE – 6:

Whenever the Pre-Acquisition dividend is received and credited to Investment account and then the shares are sold then, to calculate Gain/Loss on sale, the average cost per share will be calculated after deducting the pre-acquisition dividend from cost.

Example 11:

Opening Balance on 1st April in Shares = 1,000 no. purchased at 25/-. On 1st May, 600 no. of shares purchased at 32/-; on 1st June Bonus shares received 100 no.; on 1st August Dividend Received 10% (Face value of shares Rs. 10), on 1st December 250 no. of shares sold at 29.5/- each.

2. RULES FOR INVESTMENT IN DEBENTURES/BONDS

RULE – 7:

When Debentures are purchased multiple times on different dates at different prices then we shall calculate Average Cost per debenture to calculate gain/loss on sale (Avg. cost is taken when FIFO is not required).

RULE – 8:

If in any question Cum Interest price and Ex Interest price is given, we shall always record investment at Ex Interest Price. Because Ex Interest Price is real Market Price. We should record the Interest paid separately through Profit & Loss Account.

Example 12:

Purchased 1200 no of debentures @99/- (Ex-interest) as on 1st November. Last interest was due on 30th September. Rate of Interest is 9% p.a. Face Value is 100/-

Answer: Investment Cost = 1,18,800 and Interest Expense on purchase = 900

Example 13:

Mr. Amit Purchased 1200 No. of Debenture @ 99.5/- (Ex. Interest Price). Date of Purchase is 1st November. Interest is due on 30th Sep. and 31st March (Six monthly Basis). Interest is 9% p.a.

Answer: Investment Cost = 1,19,400/- Interest Expense on purchase = 900 and Interest Received on 31st March = 5,400/-

Example 14:

FY 23-24, on 1st June, 500 no. of debentures are purchased at 96/- Ex-interest. Interest is payable on every six months on 30th Sep and 31st March at 12% p.a. On 1st Jan, 300 no. of debentures are purchased at 101/- cum-interest. Calculate Avg. cost per debentures after both purchases and Interest thereon.

Answer: Avg. Cost = 96.75/-; Interest First Half = 3,000 and 2nd Half = 4,800

RULE – 9:

In case of Debentures/Bonds, while sale of these securities to calculate Gain/Loss on sale, always compare Ex Interest Purchase with Ex Interest Sale after adjusting Brokerage if any.

Gain/Loss = [(Ex-interest sale value) – (Brokerage)] – [(Ex-interest purchase value) + (Brokerage)]

Example 15:

FY 23-24

Company pays Interest on Six monthly Basis i.e 30th September & 31st March. On 1/4/23, Mr. Jai bought 1000 no. of Debentures at 99/- Ex. Interest Price. on 1/9/23, He again bought 1200 No. of Debentures at 98/- Ex. Interest Price. Interest Rate = 12%. p. a.

500 Debenture Sold on 1st October at 99.5/- Cum Interest.

700 Debenture Sold on 1st Jan 2024, at 102.5/- Cum Interest.

Prepare Investment A/c.

Example 16:

FY 23-24

Mr. Rahul Purchased 400 No. of 6% Debenture at 95/- Ex-Interest on 1/6/23.

He again purchased 500 No. at 97/- Cum-Interest an 1/9/23.

He Sold 300 no. at 99.5/- Cum Interest on 1st December.

He again Purchased 100 No. at 97.25/- Ex-Interest on 1st March 2024.

Interest is due on every 30/9 & 31/3

Prepare Investment A/c.

3. COMMON RULES FOR SHARES AND DEBENTURES

RULE – 10:

We should always record the Investment (at the time of purchase) at Acquisition cost and Not at Face value.

RULE – 11:

Brokerage paid at the time of Purchase shall be added to cost of Investment. Brokerage paid at the time of sale shall be deducted from sale proceeds.

RULE – 12:

To calculate Brokerage, we have to make calculation on Actual Cost always (Not on Face Value) if nothing is mentioned in Question.

RULE – 13:

Interest and Dividend shall always be calculated on Nominal value (Face Value) and Not on Cost Price.

RULE – 14:

Interest Income Shall always be Calculated on Time Proportion Basis (i.e., Month Wise)

But Dividend Income shall always be calculated on Annual Basis only unless it is Interim Dividend.

Note: Dividends are of Two types, Final Dividend (Annual Period) and Interim Dividend (less than 12 months period)

Example 17:

Siddhant has 900 No. of Share at total Cost of 1,20,000/-. He got Bonus shares of 450 No. on 1/6/23. He got Right issue share of 300 No. on 1/8/23. He got Interim Dividend on 1st October @ 6%. How much Dividend will he get? How much is Post Acquisition Dividend?

Example 18:

Investor has 3000 shares of 32,00,00/- at Beginning of year. Investor acquired another 1800 share at 115/- on 1/5/23. Investor got Bonus of 1:2 on 1st June. Investor got Right issue Offer of 1:6 on 1st July. Out of which 30% transferred to third party & 20/-each & rest 70% subscribed at 90/- each. Investor got dividend of 9% on 31st July. Investor Sold 2100 Shares at 110/- on 1st December.
Show Investment a/c

7. MCQ's from ICAI Resources

1. The cost of Right shares is
   (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.

2. Long term investments are carried at
   (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.

3. Current investments are carried at
   (a) Fair value.
   (b) cost.
   (c) Cost and fair value, whichever is less.
   (d) Cost and fair value, whichever is higher.

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 `
   (a) 2,70,000.
   (b) 1,50,000.
   (c) 1,20,000.
   (d) 1,70,000.

5. Cost of investment includes
   (a) Purchase costs.
   (b) Brokerage and Stamp duty paid.
   (c) Both (a) and (b).
   (d) none of the above.

6. A current investment is an investment
   (a) That is readily realisable.
   (b) That is intended to be held for not more than one year from the date on which such investment is made.
   (c) Both 1and 2
   (d) That is intended to be held for not more than two years from the date on which such investment is made.

ANSWERS	1	2	3	4	5	6
	A	B	C	A	C	C

6 ACCOUNTING STANDARD – 16 BORROWING COSTS

1. MEANING of BORROWING COSTs

Borrowing Cost is the:

(a) Interest and

(b) Other cost

that is incurred by an enterprise in connection with borrowing of funds.

The following exclusive points should be considered for the purpose of borrowing cost:

- Interest on Loans (Short term or Long term).
- If entity has incurred any ancillary cost for arrangement for funds, then amortised part of such cost should be treated as borrowing cost every year.
  Examples: Brokerage, stamp duty for Loan Agreement etc.
- Amortised part of Discounts/premiums on issue or redemption of debentures.
- Amount of Interest (finance charges) which is paid or payable on lease liability recognized in accordance with AS 19.
- Exchange Difference arising from Foreign Currency Loans to the extent of difference in Interest cost AS 11.

Author's Note:

1. Equity Dividend is not borrowing cost.
2. Cost of issue of Equity Share Capital such as underwriting commission and other related expenses is not borrowing cost.

Example 1: - (Foreign Exchange Difference)

Vsmart took FC Loan of $50,000 on 1/4/22 @4% interest p.a. Same loan Could have been borrowed in ₹ @10.5% p.a. Exchange Rate 1/4/22 = $1 = 81.26/- & 31/3/23 = 84.57/-. Calculate Total Borrowing Cost.

Solution:

Step 1: Calculate Borrowing Cost on FC Loan: -

$50,000 x 4% = $2,000 x 84.57 = 1,69,140

Step 2: Calculate interest on Indian Loan

Loan Amount in ₹ = $50,000 x 81.26 = 40,63,000

Interest @10.5% = 4,26,615

Step 3: Saving Interest = 4,26,615 – 1,69,140 = 2,57,475

Step 4: Calculate Exchange Loss:
$50,000 x (84.57 – 81.26) = 1,65,500

Borrowing Cost Should be Lower of: -
(a) Saving in Interest – 2,57,475/-
(Or)
(b) Exchange Loss – 1,65,000/-

Total Borrowing Cost = 1,69,140 + 1,65,500 = 3,34,640

2. MEANING OF QUALIFYING ASSETS

Qualifying Asset means:

- An ASSET
- that takes Substantial period of time
- to get ready for intended use or sale.

Note 1: Normally a period of 12 months is considered to be the substantial period of time. However it is not defined, it can be considered as per the judgement of the entity. If question is silent we can assume that asset is taking substantial period.

3. TREATMENT OF BORROWING COSTs

As per AS 16, if borrowed funds are applied to:

- Acquisition; (A)
- Construction; (C) or
- Production (P)

of any Qualifying Asset, then borrowing cost on such borrowed funds shall be Capitalized.

If any borrowing cost is not having any connection with Q.A. than such amount should be transfer to Profit and Loss account.

4. TYPES OF BORROWINGS & BORROWING COSTS

There can be two types of borrowings which are as follows: -

A. **Specific Borrowing:** Loan is taken for specific qualifying asset
B. **General Borrowing:** Loan is not for any specific qualifying asset. It can be used for any purpose or for multiple assets.

Specific Borrowing Cost	General Borrowing Cost
Entire borrowing cost shall be capitalized from the date of 1st expenditure on qualifying asset. (i.e. start capitalization of entire borrowing cost from the date of 1st expenditure irrespective of expenses on different dates)	Capitalization shall be done expenditure wise (i.e. from the date of each expenditure on qualifying asset). To capitalize the borrowing cost we have to calculate weighted average of the borrowing rate (WABR) as under: $\frac{\text{Total Borrowing Cost incurred during the year} \times 100}{\text{Total Borrowings O/s during the Year}}$ Expenditure on QA x WABR (%) x Time Weight
If expenditure on qualifying asset is incurred out of specific as well as general borrowed funds then we shall first use specific borrowings if such borrowing is available on the date of expenditure.	

EXPENDITURE TO WHICH CAPITALISATION RATE IS APPLIED:

Expenditure Already incurred on QA (including Borrowing cost capitalized till last year)	XXX
Add: Expenditure incurred in CY (in Cash or payable)	XXX
Less: Progress Payments or Grants received during the CY	(XXX)
Total Expenditure on which WABR shall be applied	XXX

IMPORTANT POINT:

If any enterprise has earned temporary income by investment of unused borrowed funds, then amount of temporary income should be deducted against total borrowing cost and only thereafter principals of recognition should be applied.

Example 3

On 1st May 20X1, DEF took a loan of Rs. 1,000,000 from a bank at the annual interest rate of 5%. The purpose of this loan was to finance a construction of a production hall.

The construction started on 1 June 20X1. DEF temporarily invested R. 8,00,000 borrowed money during the months of June and July 20X1 at the rate of 2% p.a.

What borrowing cost can be capitalized in 20X1? (Assume all interest was paid).

ANSWER:

Although the funds were withdrawn on 1st May, the capitalization can start only on 1st June 20X1 when all criteria were met (the construction had not started until 1st June).

Calculation:

- Interest expense: Rs. 10,00,000 x 5% x 7/12 = Rs. 29 167
  Note: this is very simplified calculation and if the loan is repayable in installments, then you need to take the real interest incurred (by the effective interest method).
- Less investment income: Rs. 800 000 x 2% x 2/12 = Rs. 2 667
- Total borrowing cost to capitalize in 20X1: Rs. 26,500

Example 4: - (Specific Borrowing Capitalization)

Entity took a loan of 15,00,000 on 1/4/22 @10% p.a. Interest for the purpose of Building Construction

Expenditure on Construction was made on 1/Aug in lumpsum of Rs. 18 lakhs

Calculate Capitalisation of Borrowing Cost if Construction is still WIP as on Year End.

Solution:

Total Borrowing Cost = 15,00,000 x 10% = 1,50,000

Borrowing Cost Capitalisation shall commence from the date of Expenditure incurred till year end.

Therefore, Borrowing Cost to be Capitalised (for 8Months) = 1,50,000 x 8/12 = 1,00,000

Borrowing Cost to be Charged to P&L = 50,000

Example 5: -

Continuing with above Example 4. Building Construction completed on 31/July in next year i.e. FY 23-24.

Calculate Borrowing Cost to be Capitalised in FY 23-24 if 3,00,000/- Loan was repaid on 1/4/23.

Solution:

Total Borrowing Cost for 23-24 = 12,00,000 x 10% = 1,20,000

Borrowing Cost in 23-24 shall be Capitalised till July 23 only since w.e.f. 1/Aug/23. Building is ready to use. Hence, No Capitalisation from 1/Aug

1,20,000 x 4/12 = 40,000/- (Capitalised)

Borrowing Cost Transfer to P&L A/c = 1,20,000 – 40,000 = 80,000

Example 6: - (Specific Borrowing)

Entity took a SBI Loan of 25,00,000 @12% p.a. on 1/4/22 for Building Construction:

1/5/22 = 15,00,000

1/Aug/22 = 10,00,000

Construction Completed on 28/Feb/23

Calculate Borrowing Cost to be Capitalised.

Solution:

Capitalisation Shall start from 1/May till 28/Feb

1/May = 15,00,000 x 12% x 10/12 = 1,50,000

1/Aug = 10,00,000 x 12% x10/12* = 1,00,000

Borrowing Capital to be Capitalised = 2,50,000

Borrowing Capital to be transfer to P&L A/c = 3,00,000 – 2,50,000 = 50,000

***Note: -** As per AS 16, Under specific Borrowing, Capitalisation Shall Commence from the date of First Expenditure incurred on Qualifying Asset for all Expenditure incurred further.

Example 7: - Financial Year 22 – 23

1st April	SBI Loan @10%	20 lakhs
1st June	HDFC Loan @12%	25 lakhs
1st Dec	ICICI Loan @10.5%	30 lakhs
		75 lakhs

Calculate Weightage Average Borrowing Rate.

Solution:

Interest on SBI	20,00,000 x 10%	2,00,000
Interest on HDFC	25,00,000 x 12% x 10/12	2,50,000
Interest on ICICI	30,00,000 x 10.5% x 4/12	1,05,000
Total BC		**5,55,000**

Weighted Average Borrowing Rate (or) Weighted Average Capital Rate.

= $(5{,}55{,}000)/\left(\frac{20{,}00{,}000x12}{12}\right)+\left(\frac{25{,}00{,}000x10}{12}\right)+\frac{30{,}00{,}000x4}{12})$ x 100

= 5,55,000 / 50,83,333 x 100

= 10.918%

Example 8: -

Continuing with above Example above with following Information:

Out of above Borrowings, entity has incurred following Capital Expenditure as Qualifying Asset: -

Date	Qualifying Asset	Expenditure
1/4/22	Machine A	6,50,000
1st June	Machine B	20,00,000
1st July	Building A	18,00,000
1st Jan	Building A	21,00,000
		65,50,000

How Much Borrowing Cost to be Capitalised in Qualifying Asset & How Much Transfer to Profit & Loss A/c.

Solution

Weighted Average Capital Rate = 10.918% p.a.

This Rate shall be applied to the Expenditure Amount

1) Machine A: 6,50,000 x 10.918% x 12/12 = 70,967/-
2) Machine B: 20,00,000 x 10.918% x 10/12 = 1,81,967/-
3) Building A: 1/7 = 18,00,000 x 10.918% x 9/12 = 1,47,393/-
4) Building A: 1/Jan = 21,00,000 x 10.918% x 3/12 = 57,320/-

   Total on Building A = 2,04,713/-

Total BC Capitalised on all Qualifying Assets = 4,57,647/-

Total BC Transfer to P&L = 5,55,000 – 4,57,647 = 97,353/-

Example 9: -

An Entity has Following Loans for the year 22-23: - (Rs. In '000)

Particular	As on 1/4/22	As on 31/3/23
18% Bank Loan	1,000	1,000
16% Term Loan	3,000	3,000
14% Debenture (Specific)	-	2,000

Debentures are issued for the purpose of Construction of Office Building (Development is not yet started during 22-23) issue date is 1/7

On 1/04/22, entity begin the construction of a plant by using Exiting Borrowings

1/04/22 = 5,00,000 Expenditure

1/01/23 = 25,00,000 Expenditure

Calculate total Borrowing Cost & Borrowing Cost to be Capitalised as well as charged to P&L

Solution:

1) Debenture issued is a Specific Borrowing for Building Construction.
   Since, No Construction activity is started Hence entire Interest on Debenture shall be transfer to P&L a/c.
   20,00,000 x 14% x 9/12 = 2,10,000
2) Calculation of Weighted Average Capital Rate: -
   18% Bank Loan = 10,00,000 x 18% = 1,80,000
   16% Term Loan = 30,00,000 x 16% = 4,80,000
   40,00,000 6,60,000
   Weighted Average Capital Rate = 6,60,000 / 40,00,000 x 100 = 16.5%

3) **Capitalisation of General Borrowing Cost:**

1/4	5,00,000 x 16.5%	82,500
1/1	25,00,000 x 16.5% x 3/12	1,03,125
	Total Borrowing Cost to be Capitalised	**1,85,625**

4) **Borrowing Cost transfer to Profit & Loss from General Borrowing.**

Total Borrowing Cost	6,60,000
Capitalised Borrowing Cost	1,85,625
Borrowing Cost transfer to P&L A/c	**4,74,375**

Example 10: -

FY 22-23 Entity is in Construction of Office Building out of general borrowings.

Date of Expenditure

1/Dec/22 = 1,00,000; 1/Jan/23 = 2,50,000; 1/Feb/23 = 2,50,000 & 1/March/23 = 2,50,000

Following are General Borrowings:

(a) 10% Debentures issued during the year = 20 lakhs

(b) One Bank OverDraft Facility availed as under: -
5,00,000 during Dec to Feb & 7,50,000 in March

Interest on Over Draft is 15% in Dec & 16% from Jan to March

Calculate Weighted Average Capital Rate.

Solution:

Working Note 1: Calculation of Total Borrowing Cost

Particular	Amount
10% Debentures for Full Year (20,00,000 x 10%)	2,00,000
5,00,000 Over Draft @15% on Dec (5,00,000 x 15% x 1/12)	6,250
5,00,000 Over Draft @16% in Jan & Feb (5,00,000 x 16% x 2/12)	13,333
7,50,000 Over Draft @16% in March (7,50,000 x 16% x 1/12)	10,000
	2,29,583

Working Note 2:

Total Borrowing Outstanding During the Year.

Debentures	20,00,000 x 12/12	20,00,000
OD	5,00,000 x 3/12	1,25,000
	7,50,000 x 1/12	62,500
		21,87,500

Weighted Average Capital Rate = 2,29,583 / 21,87,500 x 100 = 10.495%

1/Dec/22	1,00,000 x 10.495% x 4/12	3,498
1/Jan/23	2,50,000 x 10.495% x 3/12	6,559
1/Feb/23	2,50,000 x 10.495% x 2/12	4,373
1/March/23	2,50,000 x 10.495% x 1/12	2,186
	Borrowing Cost Capitalised	**16,616**

Example 11: - (Specific & General Borrowing)

Entity took a Loan from Axis Bank for Rs. 2,00,000 for Building Construction @9% p.a. on 1/4/22.

Entity has other two general Borrowings as Under:

10% SBI Loan = 9,00,000

12% HDFC Loan = 6,00,000

Expenditure on Building Construction are as Under:

1/4/22 – 1,20,000; 1/5/22 – 4,00,000; 1/7/22 – 6,80,000 & 1/12/22 = 4,00,000

Calculate BC to be Capitalised

Solution:

Whenever Specific & General both borrowings are applied to a Qualifying Asset. We shall assume that Specific borrowing is applied first

Working Note 1: Weighted Average Capitalisation Rate.

Borrowings	Borrowing Cost
9,00,000	90,000
6,00,000	72,000
15,00,000	**1,62,000**

1,62,000 / 15,00,000 x 100 = 10.8%

Working Note 2: Capitalisation

Date	Particular	Specific	General
1/4/22	Expenditure out of Specific Loan	1,20,000 x 9% = 10,800	-
1/5/22	Total Expenditure	80,000 x 9% = 7,200	3,20,000 x 10.8% x 11/12 = 31,680
1/7/22	Expenditure out of General Loan	-	6,80,000 x 10.8% x 9/12 = 55,080
1/12/22	Expenditure out of General Loan	-	4,00,000 x 10.8% x 4/12 = 14,400
	Borrowing Cost to be Capitalised	18,0000	1,01,160

Borrowing Cost Charged to P&L A/c:

Out of Specific Loan = Nil

Out of General Loan = 1,62,000 – 1,01,160 = 60,840

Example 12: -

Financial Year 22-23

Date	Borrowings	Amount	Purpose	Ancillary Cost
1/4/22	13% ICICI Loan	50 Lakhs	Multiple Qualifying Asset	2,00,000
1/9/22	14% HDFC Loan	40 lakhs	Plant & Machinery	5%
1/12/22	15% Bonds	30 Lakhs	Multiple Qualifying Asset	3.5%

Expenditure on Qualifying Asset: -

- Plant & Machinery = 60 lakhs
- Office Building Construction = 40 lakhs
- Inventory (QA) = 20 lakhs

Calculate Borrowing Cost to be Capitalised.

Solution:

Working Note 1: Specific Borrowing Cost

Interest	40,00,000 x 14% x 7/12	3,26,667
+ Ancillary Cost	40,00,000 x 5%	2,00,000
		5,26,667

Working Note 2: General Borrowing Cost

(a) ICICI	50,00,000 x 13% x 12/12	6,50,000
+ Ancillary Cost		2,00,000
		8,50,000

(b) Bonds	30,00,000 x 15% x 4/12	1,50,000
+ Ancillary Cost		1,05,000
		2,55,000

Total General Borrowing Cost = 11,05,000

Working Note 3: Weighted Average Capital Rate

11,05,000 / ((50,00,000 x 12/12) + (30,00,000 x 4/12)) x 100 = 18.416% p.a.

Working Note 4:

1) Plant & Machinery:

i. 40,00,000 out of Specific Borrowing. Therefore, 5,26,667 Capitalised Borrowing Cost

ii. 20,00,000 out of General borrowing

20,00,000 x 18.416% = 3,68,320

2) Office Building out of General Borrowings

40,00,000 x 18.416% = 7,36,640

3) Inventory

20,00,000 x 18.416% = 3,68,320

Conclusion: Total Gross Borrowing Cost Capital = 11,05,000

No P&L at all

Example 13:

Entity Borrowed on 1/4/22 9%, 30 lakhs for Construction of two Qualifying assets. Construction Begins from 1/4/22. The loan was availed on 1/4/22 & started utilizing in Qualifying Asset. Remaining funds were temporarily invested @7% p.a.

	QA 1	QA 2
Expenditure on 1/4/22	5,00,000	10,00,000
Expenditure on 1/10/22	5,00,000	10,00,000

Calculate Total Borrowing Cost & Capitalised Borrowing Cost.

Solution:

Particulars	QA 1	QA 2
Borrowing Cost	10,00,000 x 9% = 90,000	20,00,000 x 9% = 1,80,000
(-) Investment Income	5,00,000 x 7% x6/12 = (17,500)	10,00,000 x 7% x 6/12 = (35,000)
Net Borrowing Cost to be Capitalised	72,500	1,45,000
Total Cost of QA (After Capitalisation)	10,72,500	21,45,000

5. CAPITALIZATION of BORROWING COSTs:

Commencement of Capitalisation:	Start capitalizing Borrowing cost from the later of following dates: a. Date of start of expenditure on A/C/P of Qualifying Asset b. Date of start of incurring interest c. Date when necessary activities started (Such as technical or administrative work prior to commencement of physical contruction)
Suspension of Capitalisation	Capitalization of Borrowing Costs shall be suspended during the extended periods in which Active Development is interrupted. Note: Borrowing costs which are related to the suspension period should be transferred to Profit and loss. However, if necessary activities are interrupted due to unavoidable reason (or) temporary delays is necessary then no need to suspend the capitalization of Borrowing cost. (eg. High water level during construction of bridge)
Cessation of Capitalisation	• Capitalization should cease when substantially all the activities necessary to prepare the qualifying asset for its intended use or sale are complete. • Cessation to take place in part if construction of qualifying asset is completed in parts and a part is capable of being used separately.

Example on Commencement of Capitalization

X Ltd is commencing a new construction project, which is to be financed by borrowing. The key dates are as follows:

(i) 15 May 20X1: Loan interest relating to the project starts to be incurred

(ii) 2 June 20X1 : Technical site planning commences

(iii) 19 June 20X1 : Expenditure on the project started to be incurred

(iv) 18 July 20X1 : Construction work commences Identify commencement date.

SOLUTION:

In the above case, the three conditions to be tested for commencement date would be: Borrowing cost has been incurred on: 15 May 20X1

Expenditure has been incurred for the asset on: 19 June 20X1

Activities necessary to prepare asset for its intended use or sale: 2 June 20X1 Commencement date would be the date when the above three conditions would be satisfied in all i.e., 19 June 20X1.

Example of Suspension of Capitalisation

Construction suspended between October 20X1 to January 20X2 during which period certain heavy construction equipments under use was shifted to another site.

In this case, capitalization of borrowing costs needs to be suspended since active development is interrupted.

Example on Cessation of Capitalisation:
H Limited, a real estate company, gives immovable property on rent. It has completed on May 31, 20X1, a commercial complex consisting of various offices that could be rented out. It expects that the commercial complex will be completely rented out by June 30, 20X1. However, due to adverse market conditions, only 10% of the commercial complex could be rented out by its reporting date of March 31, 20X2. H Limited wants to capitalise the eligible borrowing costs incurred up to March 31, 20X2.

H Limited should capitalise borrowing costs only up to May 31, 20X1. The borrowing cost incurred thereafter cannot be capitalised as the asset was ready for its intended use on May 31, 20X1. The fact that only a small portion could be rented out by March 31, 20X2, is immaterial.

Example on Cessation of Capitalisation on some part of Asset:
An entertainment park consisting of several rides and facilities, each of which can be used individually, is an example of a qualifying asset for which each part is capable of being usable while construction continues on other parts. On the other hand, in a case of an industrial undertaking such as a steel mill, all parts have to be completed before any earlier completed part can be put to use.

6. MCQ's from ICAI Resources

1. As per AS 16, all the following are qualifying assets except
   (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

2. Which of the following statement is correct:
   (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

3. Capitalisation rate considers:
   (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

4. If the amount eligible for capitalisation in case of inventory as per AS 16 is Rs. 12,000 and cost of inventory is Rs. 40,000 and its net realizable value is ` 45,000; What amount can be capitalised as a part of inventory cost.
   (a) Rs. 12,000.
   (b) Rs. 5,000.
   (c) Rs. 7,000.
   (c) Rs. 10,000.

5. X 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 capitalisation under AS 16.
   (a) 15th May, 20X1.
   (b) 19th June, 20X1.
   (c) 18th July, 20X1.
   (d) 2nd June, 20X1

6. X Limited had taken borrowing construction of buiding A and building B. The loan for both building was taken on 01.07.2019. Construction of both buidling commenced on 05.07.2019. Construction of building A was completed on 01.06.2022 & building B on 01.10.2022. Both buildings were inaugurated on 15.11.2022. The loan is to be repaid on 31.03.2028. When should capitalization of borrowing cost cease for Building A?
   (a) 01.06.2022
   (b) 01.10.2022
   (c) 15.11.2022
   (d) Capitalization should continue till 31.03.2028

7. X limited has approved a plan for construction of building on 14.05.2022. It has finalized the vendor on 20.06.2022. Borrowing cost is due to be paid from 01.07.2022. First installment of borrowing cost is made on 01.08.2022. Consturction of building started from 15.07.2022. When should Capitalisation of borrowing commence?
   (a) 01.07.2022
   (b) 01.08.2022
   (c) 15.07.2022
   (d) 14.05.2022

ANSWERS	1	2	3	4	5	6	7
	C	C	A	B	B	A	C

7 ACCOUNTING STANDARD – 19 ACCOUNTING FOR LEASES

"The higher you go, the more challenges you face.
Every New Levels Attract new devils"

1. IMPORTANT DEFINTIONS

(1) What is Lease?

A Lease is

- A contract between lessor and lessee
- where lessor provides the right to use of an asset
- for a specified period
- in exchange for consideration (lease rent).

(2) Types of Leases?

- **Finance Lease:**
  When substantial risks and rewards of ownership of asset are transferred to lessee.

- **Operating Lease:**
  Any lease which is not a Finance Lease

(3) Indicators of Finance Lease:

AS 19 outlines some situations that would normally lead to a lease being classified as a finance lease:

1. **Ownership:** The *lessor transfers ownership* of the asset to the lessee by the end of the lease term. (Hire Purchase)
2. **Purchase Option:** The lessee *has the option to purchase the asset at a price* that is expected to be *sufficiently lower* than the fair value at the date of the option exercisability. It is reasonably certain, at the inception of the lease, that the option will be exercised
3. **Lease Term:** The *lease term is for the major part (at least 75%) of the economic life* of the asset even if the title is not transferred.
4. **PV of MLP:** At the inception of the lease the present value of the minimum lease payments amounts to at least substantially (at least 90%) all of the fair value of the leased asset.
5. **Specialized Asset:** The leased assets are of such a specialized nature that only the lessee can use them without major modifications. (i.e. customized asset for lessee's use)

(4) Important Dates under Leases –

Inception of the Lease	Commencement of the Lease
Date of Lease agreement or Date of Commitment by Parties whichever is earlier. As at this date, a lease is classified as either Finance or Operating lease. Also, Fair Value is determined on this date.	Date on which Asset is Available for Lessee As at this date, Lessee and Lessor starts accounting of leases.

(5) Other Important Terms

Initial direct costs (IDC)	Any Cost incurred at the commencement of lease by lessee or lessor for arranging the lease. Such as agreement cost, brokerage, Initial repairs and maintenance etc
Contingent Rent	It is a variable rent which may be paid by lessee only on fulfilment of certain conditions such as Additional rent (per Km) to be paid in case of excess running of Car taken on lease.
Residual Value	Value of Asset that can be realised at the end of useful life of Asset.

EXAMPLE 1: (Identification of Lease)

Asset is taken on Lease for 3 years; Economic Life is 6 Years.

Down Payment = 1,00,000/-; Annual Lease Payment = 3,00,000/-; Guaranteed Residual Value = 50,000/-

Fair Value of Asset at Inception = 8,50,000; Discount Rate = 10%

Identify the type of Lease?

SOLUTION:

If major Economic Life is covered under Lease term then it may be treated as Finance Lease

Here, it is difficult to conclude that it is a finance lease based on above condition, Since Economic life is 6 Years & Lease term is 3 Years.

If Sum of PV of Minimum Lease Payment is Equal to or subsequently covers initial Fair Value of Asset, then it may be treated as Finance Lease.

Year end	MLP	PV @10%
0	1,00,000	
1	3,00,000	
2	3,00,000	
3	3,50,000	
		8,83,621

Since, FV is 8,50,000, it can be seen from above Calculation that lessor is able to recover its entire Fair Value/Cost. Therefore, it is Finance Lease.

2. RECOGNITION AND MEASUREMENT OF FINANCE LEASE IN THE BOOKS OF LESSEE

Lessee shall measure and recognise the followings in the books:

(a) Asset on Lease Account

(b) Lease Liability Account

1. INITIAL RECOGNITION AND MEASUREMENT

<table>
<tr><td>Initial Recognition of Lease Liability and Asset on Lease</td><td>Lower of:
Present Value (PV) of MLP or
Fair Value of Asset

Note: PV shall be calculated using following discounting rates:
(a) Interest Rate implicit in lease (1st Priority); or
(b) Lessee's incremental borrowing rate</td></tr>
<tr><td>Minimum Lease Payment (MLP)</td><td>Initial Down Payment
(+) Annual Lease Rents
(+) Residual Value Guaranteed by Lessee (GRV)</td></tr>
<tr><td>Initial Direct Cost (IDC) incurred by Lessee</td><td>IDC shall be capitalized to the cost of Asset</td></tr>
<tr><td>Accounting Entry of Initial Recognition</td><td>Asset on Lease A/c Dr. (including IDC)
To Lease Liability A/c
To Bank A/c (IDC Payment)

Lease Liability A/c Dr. (Payment of DP)
To Bank A/c</td></tr>
<tr><td>Depreciation</td><td>Asset on Lease is subject to depreciation under AS 10 over the Lease Period or Life of Asset whichever is lower.</td></tr>
<tr><td>Finance Charges (Interest Cost) on Lease Liability</td><td>Interest shall be calculated using the same discounting rate which was used earlier to calculate PV of MLP.
Interest shall be calculated on Opening Balance of Lease Liability as under:
<table><tr><th>Year</th><th>Opening</th><th>Interest</th><th>Payment</th><th>Closing</th></tr><tr><td>(1)</td><td>(2)</td><td>(3) = (2) x Rate</td><td>(4)</td><td>(2+3-4)</td></tr><tr><td></td><td></td><td></td><td></td><td></td></tr></table></td></tr>
<tr><td>Other Journal Entries</td><td>a) <u>For Charging Depreciation:</u>
Depreciation A/c Dr.
To Asset on Lease</td></tr>
</table>

	b) For Charging Finance Cost (Interest): Finance Charges A/c Dr. To Lease Liability A/c **c)** For Payment of Lease Rent: Lease Liability A/c Dr. To Bank A/c **d)** Transfer to Profit and Loss: Profit and Loss A/c Dr. To Depreciation A/c To Finance Charges A/c

Note:

Interest Rate Implicit in the Lease (i.e. IRR) **(Consider always from Lessor's point of view)**	It is the rate at which- PV of (LP + UGRV) = FV at Inception + IDC (Refer Example 3)
Lessee's Incremental Borrowing Rate	It is the rate at which Lessee can Borrow additional funds over a similar term, security for the same amount of underlying asset.

Example 2: (Finance Lease – Books of Lessee)

Lease Term = 5 Years; Fair Value = 25,00,000; Down Payment = 3,00,000; Annual Lease Payment = 5,00,000;

Guaranteed Residual Value = 4,00,000 & Discount Rate is 12%. Show Accounting for Lessee.

Solution: -

(i) Asset shall be recorded at lower of: -

(a) Fair Value = 25,00,000

(or)

(b) PV of MLP = 24,42,500

Therefore, Asset = 24,42,500

Beginning of Lease

Asset on Lease A/c Dr. To Lease Liability A/c (Being Asset taken on 5 Years Lease)	24,42,500	24,42,500
Lease Liability A/c Dr. To Bank A/c (Being Down Payment Discharged)	3,00,000	3,00,000

(ii) Calculation of Interest: -

Year	Opening O/s	Interest @12%	Payment	Closing
1	21,42,360	2,57,100	5,00,000	18,99,600
2	18,99,600	2,27,952	5,00,000	16,27,552
3	16,27,552	1,95,306	5,00,000	13,22,858
4	13,22,858	1,58,743	5,00,000	9,81,601
5	9,81,601	81,601 (b/f)	9,00,000	0

1st Year end:

Finance Charges (Interest) A/c Dr. To Lease Liability A/c (Being Interest @12% Charged)	2,57,100	2,57,100
Lease Liability A/c Dr. To Bank A/c (Being Annual Lease rent discharged)	5,00,000	5,00,000
Depreciation A/c Dr. To Asset on Lease A/c (Being Depreciation Charged)	4,88,500	4,88,500
Profit & Loss A/c Dr. To Interest Expenses A/c To Depreciation A/c (Being Expenses Charged to P&L)	7,45,600	2,57,100 4,88,500

3. PART 5 – RECOGNITION AND MEASUREMENT OF LEASE CONTRACT IN THE BOOKS OF LESSOR

KEY CONCEPTS FOR UNDERSTANDING LESSORS ACCOUNTING

'Gross investment in the lease' (GIL) = Initial Down Payment + Annual Lease Payments + GRV + UGRV	
'Net investment in the lease' (NIL)	(PV of GIL) PV of (DP + Lease Payments + UGRV) – Initial Direct Cost
'Unguaranteed residual value'	Total Estimated Residual Value (-) GRV

ACCOUNTING FOR FINANCE LEASE

Non-dealer Lessor	Dealer or Manufacturer Lessor
Initial Recognition: Lease Receivable A/c Dr. (Net Invst. in Lease) Bank A/c Dr. (Down Payment) To Asset (PPE) A/c (Carrying Amt.) Difference in above entry is transfer to P&L a/c **Initial Direct Cost (IDC):** IDC is part of Cash Flows and will be considered under Interest Rate Calculation and then it is deducted from lease receivable. **Year End:** Lease Receivable A/c Dr. To Finance Income (P&L) A/c Bank A/c Dr. To Lease Receivable A/c (Collection of Lease Rent)	**Initial Recognition:** Dealer Lessor shall record Sale at commencement of Lease: Lease Receivable A/c Dr. (Net Invst. in Lease) COGS A/c Dr. (Balancing Fig.) To Sale A/c (Lower of FV or PV of MLP) To Inventory A/c (Carrying Amt.) Sale (-) COGS = Profit on Outright Sale **Initial Direct Cost (IDC):** IDC is directly transferred to Profit and Loss account and not a part of Interest Rate Calculation. **Year End:** Same as Non-dealer Lessor's Accounting
Calculation of Unearned Finance Income: Disclose Unearned Finance Income every year: Gross Investment in Lease (-) Net Investment in Lease	
Subsequent Measurement at Balance Sheet Date: At every BS date, Lease Receivable shall be recognised at Current Net Investment in Lease (i.e. PV of Remaining Lease Payments + Re-estimated UGRV). UGRV shall be reviewed atleast once in a year and if there is any reduction in the estimated UGRV the reduced amount shall be considered, this will result in reduction of Finance Income of the lessor.	

Example 3: (Calculation of Interest Rate Implicit in Lease)

FV = 20,00,000, Annual Lease Rent = 4,50,000 p.a., Term = 5 years, GRV = 1,00,000, UGRV = 2,00,000. Calculate Interest Rate Implicit in Lease.

Solution

At 9%, PV of Inflows = 19,45,322

At 8%, PV of Inflows = 20,00,894

% Increase	1	X
Amount Decrease	55,572	894

8% + 894/55,572 = **8.016%**

EXAMPLE 4: (Finance Lease – Non Dealer Lessor)

(Finance Lease-Books of Lessor)

Lease Term = 5 Years; DP = 1,00,000; Annual Lease Rent = 2,50,000 Per Anum; Guaranteed Residual Value = 80,000; ERV = 1,50,000 & Interest rate Implicit in lease = 9%

SOLUTION:

	Year	Amount	PvF @ 9%
Down Payment	0	1,00,000	
Lease Rent	1	2,50,000	
Lease Rent	2	2,50,000	
Lease Rent	3	2,50,000	
Lease Rent	4	2,50,000	
Lease Payment	5	2,50,000	
Guaranteed Residual Value	5	80,000	
UGRV	5	70,000	
	GIL	15,00,000	11,69,903

Unearned Finance Income = Gil – Nil
= 15,00,000-11,69,903
= 3,30,097/- (For 5 Years)

Beginning of Lease:

Beginning of Lease: Lease Receivable a/c To Asset A/c (Being lease Receivable recognised @ NIL)	Dr.	11,69,903	11,69,903
Down Payment Received: Bank A/c To Lease Receivable A/c	Dr.	1,00,000	1,00,000

Finance Income on (11,69,903-1,00,000) X 9% i.e., 96,291/-

Year end 1st

Lease Receivable a/c To Finance Income A/c	Dr.	96,291	96,291

	Bank A/c Dr. To Lease Receivable A/c	2,50,000	 2,50,000	

Example 5: (Finance Lease - Dealer lessor)

Fair Value of Asset given = 15,00,000, Lease Rent p.a. = 5,50,000, Term = 3 years, GRV = 1,00,000, UGRV = 50,000, IRI = 10%, Book Value of Inventory Which is Leased = 13,80,000. This is Finance Lease. Show Accounting as per AS 19.

Solution:

1) Net Investment in Lease:

Years	Amounts	PV @10%
1	5,50,000	14,80,465/-
2	5,50,000	
3	5,50,000 + 1,50,000	

2) PV of MLP: -

Years	Amounts	PV @10%
1	5,50,000	14,42,900/-
2	5,50,000	
3	5,50,000 + 1,00,000	

3) Lease Receivable to be recognised at NIL i.e., 14,80,465/-

4) Sales shall be recognised at Lower of

(a) FV or (b) PV of MLP i.e., Sales = 14,42,900

5) Journal Entry: -

Lease Receivable A/c	Dr.	14,80,465	
COGS A/c	Dr.	13,42,435	
To Sales A/c			14,42,900
To Inventory A/c			13,80,000
Trading A/c	Dr.	13,42,435	
To COGS A/c			13,42,435
Sales A/c	Dr.	14,42,900	
To Trading A/c			14,42,900

Trading A/c

COGS	13,42,435	Sales	14,42,900
Profit on Outright Sale	1,00,465		

EXAMPLE 6: (Calculation of Annual Lease Rent)

Fair Value of Asset = 15,00,000; Lease Term = 4 Years; IRI 12%; Down Payment = 1,00,000; GRV = 0 & UGRV = 1,25,000

Annual Lease Rent = Not Known (But it is equal every year)

Calculate Annual Lease Rent

SOLUTION:

Let us Assume, Annual Lease Rent is X

Year	Amount	Pv	Amount
0	1,00,000	1	1,00,000
1	X	0.893	0.893X
2	X	0.797	0.797X
3	X	0.712	0.712X
4	X	0.636	0.636X
4	1,25,000	0.636	79,500
			15,00,000

1,00,000 + 3.038x + 79,500 = 15,00,000

X = 4,34,661

Therefore, Annual Lease Rent is 4,34,661/-

4. OPERATING LEASE

Treatment of Operating lease is same for Lessor and Lessee. Lessor shall recognise Lease income and lessee shall recognise lease expense on straight line basis (SLM) unless any other basis is more appropriate and reliable than SLM.

Particulars	Treatment
Initial Measurement	Not Required
Recognition of Lease Income for Lessor	Bank A/c Dr. To Lease Rent Income A/c (Difference is transferred to Lease Equalisation Account) Recognise Income on SLM basis unless another basis is more appropriate.
Recognition of Lease Expense for Lessee	Lease Rent Expenses A/c Dr. To Bank A/c Dr. To Deferred Rent A/c Dr. (Difference is transferred to Lease Equalisation Account) Recognise Income on SLM basis unless another systematic basis is more representative.
Depreciation on Asset	Depreciation shall be charged by Lessor Only because Asset is show under Lessor's Balance Sheet: Depreciation A/c Dr. To Asset A/c
Initial Direct Cost incurred by Lessor	IDC shall be deferred and Amortised by lessor and lessee over the lease term on either SLM basis or any other appropriate basis.

EXAMPLE 7: (Operating Lease)

Suppose outputs from a machine taken on a 3-year operating lease are estimated as 10,000 units in year 1; 20,000 units in year 2 and 50,000 units in year 3. The agreed annual lease payments are Rs. 25,000, Rs. 45,000 and Rs. 50,000 respectively. The total lease payment Rs. 1,20,000 in this example should be recognised in proportion of output as Rs. 15,000 in year 1, Rs. 30,000 in year 2 and Rs. 75,000 in year 3. The difference between lease rent due and lease rent recognised can be debited / credited to Lease Equalization A/c. The accounting entries for year 1 in books of lessee are suggested below

Lease Rent A/c Dr.	15,000	
Lease Equalization A/c Dr.	10,000	
To Lessor A/c		25,000
Lessor A/c Dr.	25,000	
To Bank A/c		25,000
Profit and Loss A/c Dr.	15,000	
To Lease Rent A/c		15,000

Since total lease rent due and recognised must be same, the Lease Equalisation A/c will close in the terminal year. Till then, the balance of Lease Equalisation A/c can be shown in the balance sheet under "Current Assets" or Current Liabilities" depending on the nature of balance.

5. PART 7 – SALE & LEASE BACK

A sale and leaseback transaction involves the sale of an asset and the leasing the same asset back. In this situation, a seller becomes a lessee, and a buyer becomes a lessor.

SALES AND LEASE BACK involves two transactions-

1. Sale of Asset by Seller Lessee to Buyer Lessor.
2. Lease Transaction (Finance Lease or Operating Lease)

Note: Here we have to understand the treatment of gain or loss on sale of Asset in the books of lessee (seller):

(A) Sale and Leaseback with Finance Lease

If the resulting lease is a finance lease, then in fact, the transaction is a loan securitized by the leased asset and seller / lessee keeps recognizing the asset. Any excess of proceeds over the carrying amount of the leased asset is deferred and amortized over the lease term in proportion of depreciation to be charged. (i.e. Gain/Loss is to be deferred and amortised)

Transaction 1: Sale of Asset

Bank A/c	Dr.
To Asset A/c	
To Gain on Sale A/c*	

*This Gain Shall be Deferred & Amortised over the Lease term in proportion of Depreciation to be Charged by Seller Lessee

Transaction 2: Finance Lease

Lease Asset A/c	Dr.
To Lease Liability A/c	

Lower of (a) FV or (b) PV of MLP

(B) Sale and Leaseback with Operating Lease

If the resulting lease is an operating lease, then a seller/lessee **derecognizes the asset,** and a buyer/lessor recognizes the asset. Further accounting treatment is as follow:

1. **Important Information: -**

   SP means Actual Sale price of Asset (Agreed Contract Value)

   CA Means Carrying Amt. (Book Value) of Asset

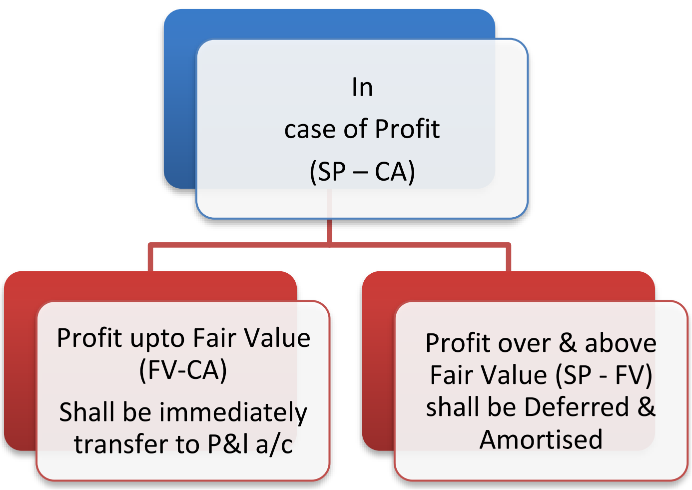
   FV mean Fair Value of Asset (Market Value)

2. **Important Rules: -**

   Rule – 1: If there is a Loss (CA – SP) then transfer it immediately to P&L.

   Exceptions:- If Loss is to be Compensated with Future Lower Lease Rent. => then Loss is to be Deferred & Amortized over the Lease Term.

   Rule – 2:



   Rule – 3: Before Applying above 2 Rules, always Check if FV is lower than CA, if Yes then Impairment loss (CA – FV) shall be recognized First in P&L & then we can apply above Rule 1 & 2.

EXAMPLE 8: -

Ajay owns a Building having FV of 25,00,000/-. To arrange the Funds for Business Ajay sold its Building to Jai for ₹ 25 Lacs & at the same time Jai leases the same Building Back to Ajay. Book value of Building in the book of Ajay is 23,00,000. This is a Finance Lease back by Jai to Ajay.

SOLUTION:
(1) Who is Ajay = Seller Lessee
(2) Who is Jai = Buyer Lesser
(3) Who will Received the profit = Seller Lessee.

Under AS 19 we will discuss the A/c of profit in the book of Seller Lessee

Normally when PPE/Asset is sold, any gain or loss as sale shall be transfer to Profit and loss a/c of seller (AS 10). But this rule shall not be applied for "Sale & Lease Back Transaction". AS 19 has set specific rules for this transaction:

Sale & Finance Lease Back:

a) Who was the owner before sale of Asset?
   Ajay (seller Lessee)
b) Who has got Substantial Risk & Rewards after sales lease?
   Ajay (seller Lessee)

Conclusion: Any gain/Loss accrue to seller Lessee shall be deferred & Amortize over the lease Term in proportion of Depreciation.

(1) **Books of Seller Lessee**

Bank A/c Dr.	25,00,000	
To Asset		23,00,000
To Deferred Gain		2,00,000

(2) **Lease Back**

Asset as Lease A/c Dr.	
To Lease Liabilities A/c	

After 1 Year, Amortize the Deferred gain in Proportion of Depreciation, assuming Depreciation is 12% WDV Method = 2,00,000 X 12% = 24,000

Deferred gain A/c Dr.	24,000
To Profit & Loss	24,000

Note: Unamortized Deferred gain of 1,76,000 to be shown on Liabilities side of B/S

Example 9: (Sale and Operating Lease Back)

Journalise in each of the following cases assuming transaction is of sale and operating lease back:

Cases	Fair Value	Book Value	Sale Price
1	100000	100000	100000
2	100000	80000	100000
3	100000	120000	100000

4	100000	100000	120000
5	100000	80000	120000
6	100000	120000	120000
7	100000	100000	90000
8	100000	90000	80000
9	100000	70000	80000
10	100000	110000	80000

Answer:

1) No Profit/Loss

2) Gain 20000 => P & L immediately

3) Loss 20000

General Rule – Immediately transfer to P&L

Exception – If loss is compensated with future lease payments then Deferred &Amortised.

4) Gain = 20000 D&A

5) Gain = 40000 20K P & L

20K D&A

6) Rule-3 => Imp. Loss = 20000 P & L

Rule-2 => Profit = 20000 D&A

7) Loss = 10000 Generally P & L

If compensated with rent then D&A

8) Loss = 10000 (same as 7)

9) Gain = 10000 P & l (Rule 2)

10) Rule – 3 =>Imp. Loss 10000 P & L

Rule – 1 => Loss = 20000

6. MCQ's from ICAI Resources

1. A 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 A Ltd. The lease back is in nature of operating lease. The treatment will be
   (a) A Ltd. should amortise the profit of ₹ 10 lakhs over lease term.
   (b) A Ltd. should recognise the profit of ₹ 10 lakhs immediately.
   (c) A Ltd. should defer the profit of ₹ 10 lakhs.
   (d) B Ltd. should recognise the profit of ₹ 10 lakhs immediately.

2. In case of an operating lease – identify which statement is correct:
   (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.

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:
   (a) Useful life.
   (b) Lease term.
   (c) Useful life or lease term whichever is less.
   (d) Useful life or lease term whichever is higher.

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?
   (a) Any 1 condition fails.
   (b) Majority of the 5 conditions fail.
   (c) All 5 conditions fail.
   (d) Any 2 conditions fails.

5. The basis of classification of a lease is:
   (a) Control Test.
   (b) Risk and reward Test.
   (c) Both control test and risk and reward test.
   (d) Only reward Test

6. N Limited has entered into lease agreement for machinery from S Limited for 10 years for Rs. 1 lakh per year. Guaranteed scrap value of machinery after 15 years is Rs. 0.5 lakh unguaranteed scrap value is Rs. 0.2 lakh. Present Value of Rs. 1 lakh for 10 years is Rs. 7 lakh, Present value of Rs. 0.5 lakh after 15th year is 0.18 lakh & of Rs. 0.2 lakh is 0.07 lakh. Calculate Unearned Finance Income for S Limited.

a) Rs. 3.45 Lakh

b) Rs. 3 Lakh

c) Rs. 3.32 Lakh

d) Rs. 3.13 Lakh

7. N Limited has taken a lease of land from S Limited for 15 years. Following are the terms of lease agreement: - N Limited to make payment of Rs. 1 lakh for 15 years. - N Limited to reimburse Rs. 10,000 tax to S limited every year. - If N Limited makes petrol pump on the land, then it has to pay Rs. 50,000 extra every year. N Limited is not sure about the receipt of approval for making petrol pump. - N Limited has option to purchase land for extra Rs. 10 lakh after end of lease. However, N Limited is not sure about purchase of land. Present Value of Rs. 1 lakh for 15 years is Rs. 12 lakh, Present value of Rs. 10 lakh after 15th year is 5.5 lakh. Calculate Minimum Lease Payment for N Limited.

(a) Rs. 15 Lakh

(b) Rs. 12 Lakh

(c) Rs. 34 Lakh

(d) Rs. 24.7 Lakh

8. Which of the following would not lead to lease being classified as Finance lease?

(a) Title of the asset is not transferred but the lease term is for the major part of the economic life of the asset.

(b) The lessee has the option to purchase the asset at a price which is expected to be sufficiently lower than the fair value at the date the option becomes exercisable.

(c) The lease does not transfer substantially all the risks and rewards incident to ownership.

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

9. Which of the following would not lead to lease being classified as Finance lease?

(a) Title of the asset is not transferred but the lease term is for the major part of the economic life of the asset.

(b) The lessee has the option to

(c) purchase the asset at a price which is expected to be sufficiently lower than the fair value at the date the option becomes exercisable.

(d) The lease does not transfer substantially all the risks and rewards incident to ownership. At the inception of the lease the present value of the minimum lease payments amounts to at least substantially all of the fair value of the leased asset.

10. N Limited has taken a lease of land from S Limited for 15 years. Following are the terms of lease agreement: - N Limited to make payment of Rs. 1 lakh for 15 years. - N Limited to reimburse Rs. 10,000 taxes to S limited every year.

If N Limited makes petrol pump on the land, then it has to pay Rs. 50,000 extra every year. N Limited is not sure about the receipt of approval for making petrol pump. - N Limited has option to purchase land for extra Rs. 10 lakh after end of lease. It is beneficial for N Limited to purchase land. Present Value of Rs. 1 lakh for 15 years is Rs. 12 lakh, Present value of Rs. 10 lakh after 15th year is 5.5 lakh. Calculate Minimum Lease Payment for N Limited.

(a) Rs. 25 Lakh

(b) Rs. 17.5 Lakh

(c) Rs. 34 Lakh

(d) Rs. 24.7 Lakh

ANSWERS	1	2	3	4	5	6	7	8	9	10
	b	a	c	c	b	a	a	c	b	a

7. MCQ's Created by Jai Sir & Team

11. **At the commencement of the lease term, lessor should recognize Lease Receivable in his statement of financial position of amount equal to:**
    (a) Net Investment in the lease.
    (b) Gross Investment in the lease.
    (c) MLP + any UGRV.
    (d) All of the above.

12. **Which lease transfer substantially all risk & rewards incident to ownership of an asset?**
    a) Operating lease
    b) Finance Lease
    c) Both
    d) None

13. **A portion of the lease payments that is not fixed in amount but is based on a factor other than just the passage of the time is termed as:**
    a) House rent
    b) Contingent rent
    c) Outstanding rent
    d) Incremental rent

14. **In which type of lease, expenses like maintenance, repair and taxes are borne by the lessor:**
    a) Operating lease
    b) Finance lease
    c) Both
    d) None of the above

15. **X Ltd sold machinery having WDV of Rs. 80 Lakhs to Y Ltd. for Rs. 90 Lakhs and the same machinery was leased back by Y Ltd. To X Ltd. The lease back is operating lease. What if Fair market value of machinery is Rs. 80 Lakhs and sale price is Rs. 90 lakhs**
    a) Profit of Rs. 10 lakhs shall be transferred to P&L
    b) Profit of Rs. 10 lakhs shall be deferred & amortized over the lease period
    c) Profit of Rs. 5 Lakhs shall be transferred to P&L and Rest Rs. 5 Lakhs shall be deferred & Amortized over the lease term
    d) As fair value is equal to WDV nothing to be done.

16. **Annual lease rent = Rs. 80,000**
    Lease period = 3 years
    Fair value at inception of lease = 3,00,000

Guaranteed residual value = Rs. 28,000

Interest rate implicit = 12%

Calculate amount at which asset should be recorded in the books of lessee.

a) 2,12,076

b) 3,00,000

c) 3,04,270

d) 2,88,382

17. Unearned finance income is difference between:

a) Gross Investment & Present value of MLP

b) Net Investment & Present value of MLP

c) Gross Investment & Present value of (MPL+UGRV)

d) Gross Investment & Net Investment

18. In case of sale & lease back, if there is profit on sale, which is correct out of following:

a) Profit over & above fair value shall be transferred to P&L immediately.

b) Profit upto fair value shall be deferred & amortised over the lease period.

c) Both (a) & (b)

d) None of the above.

19. In the books of seller-lessee, if a sale and leaseback transactions results in an operating lease, and it is clear that the transaction is established at fair value, then:

a) Any profit or loss should be recognised immediately.

b) Any profit or loss should be deferred and amortised over the period for which the asset is expected to be used.

c) If there is loss, then immediately recognised in P&L statement and if there is gain then amortised over the lease term.

d) Either A or B

20. Classification of lease as Operating or Financing is done on following date:

a) The date of the lease agreement

b) The date of commitment by the parties to the principle provisions of the lease.

c) At earlier of A & B

d) The date when assets are available for use

21. What is the accounting treatment for all Initial Direct cost incurred by lessor to earn revenues from an operating lease?

a) Deferred and allocated to income over the lease term in proportion to the recognition of the rent income.

b) Recognised as an expense in the statement of profit and loss in the period in which they are incurred.

c) Added in the cost of the asset

d) Either A or B

22. On which date lessee should recognise Lease assets & Liability?

a) The date of the lease agreement

b) The date of a commitment by the parties to the principle provision of the lease.

c) At the earlier of A & B

d) The date when asset is available for use.

23. If Sale and Leaseback transaction results in an operating lease and sale price is more than fair value, the excess amount is

a) Credited to P&L statement.

b) Deferred and amortise over expected period of use of the asset.

c) Deferred and amortise over period of five years.

d) Amortised in proportion to lease payments.

24. X limited has taken machinery on Operating lease for 3 years. Initial yearly rent is Rs. 10,000. Rent is subject to 5% escalation every year. General inflation rate in the country is also 5% per year. What amount will be charged in the statement of P&L in the first year? Present value of total rent payment over 3 years is Rs. 26,051.

a) Rs. 10,508.33

b) Rs. 10,000

c) Rs. 26,051

d) Rs. 11,302.33

25. According to AS 19, if a lease agreement is signed on January 15, but the parties committed to the principal provisions of the lease on December 31 of the previous year, when should the inception of the lease be recognized?

a) January 15

b) December 31

c) The average of January 15 and December 31

d) The later of January 15 and December 31

26. A lessee enters into a lease agreement with a lessor. The lease term is 5 years, and the minimum lease payments are ₹10,000 per year, contingent rent estimated ₹5,000. Additionally, the lessee guarantees a residual value of ₹5,000 at the end of the lease term. What is the total minimum lease payment for the lessee? ₹

a) ₹50,000

b) ₹45,000

c) ₹55,000

d) ₹10,000

27. In a lease arrangement of 3 years, the lessor receives annual lease payments of ₹20,000, guarantees a residual value of ₹5,000, and expects an undiscounted unguaranteed residual value (UGRV) of ₹2,000. What is the Net Investment (GI) for the lessor if discounting rate is 10%?

a) ₹55,000

b) ₹67,000

c) ₹53,494

d) ₹25,000

28. What is unearned finance income for a lessor in a finance lease?

a) Gross investment divided by lease term.

b) Total of lease payments and residual value less present value of gross investment.

c) Gross investment less residual value.

d) Gross investment less unguaranteed residual value.

29. What does the lessee's incremental borrowing rate of interest represent in lease accounting?

a) The lessor's desired profit margin.

b) The interest rate implicit in the lease.

c) Revised interest rate implicit in the lease to get extra income through lease.

d) The rate of interest the lessee would incur to borrow funds to purchase a similar asset over a similar term and with similar security.

30. ABC Leasing, a lessor, has incurred initial direct costs, including commissions and legal fees, while negotiating and arranging a finance lease. How should ABC Leasing account for these initial direct costs?

a) Allocate them against the finance income over the lease term.

b) Capitalize them as part of the leased asset and amortize over the lease term.

c) (a) and (b) both

d) (a) or (b)

31. ABC Leasing enters into a finance lease with a lessee. The lease term is 10 years, and the interest rate implicit in the lease is 8%. How should ABC Leasing recognize unearned finance income over the lease term according to AS 19?

a) Recognize unearned finance income immediately in the first year.

b) Allocate unearned

c) finance income evenly over the lease term.

d) Systematically and rationally recognize unearned finance income based on a constant periodic return using the implicit interest rate.

e) Base unearned finance income recognition on the lessee's payment schedule.

32. ABC Leasing has leased specialized equipment to a lessee under a finance lease. The lease term is 8 years, and the estimated unguaranteed residual value is $20,000. According to

AS 19, if ABC Leasing identifies a reduction in the estimated unguaranteed residual value during a regular review, what action should be taken regarding income allocation?

a) Revise the income allocation for the remaining lease term, but only if the reduction is significant.

b) Ignore the reduction in unguaranteed residual value for income allocation purposes.

c) Revise the income allocation over the remaining lease term immediately, irrespective of the magnitude of the reduction.

d) Continue with the existing income allocation, and only adjust for the reduction in unguaranteed residual value at the end of the lease term.

33. ABC Manufacturing, acting as a lessor, sells machinery to a lessee under a finance lease arrangement. According to AS 19, if artificially low rates of interest are quoted in the lease agreement, how should ABC Manufacturing recognize the profit on the sale in its statement of profit and loss?

a) Recognize the entire profit on the sale immediately, irrespective of the quoted interest rates.

b) Restrict the profit on the sale to that which would apply if a commercial rate of interest were charged.

c) Recognize profit on the sale over the lease term, even if artificially low rates of interest are quoted.

d) Adjust the profit on the sale based on the prevailing market interest rates at the inception of the lease.

34. XYZ Ltd, a lessee, has entered into an operating lease for specialized manufacturing equipment. The lease term is 10 years. According to AS 19, under what circumstances can XYZ Ltd deviate from recognizing lease payments on a straight-line basis?

a) If the fair value of the leased equipment fluctuates during the lease term.

b) If XYZ Ltd anticipates changes in its financial position during the lease term.

c) If another systematic basis is more representative of the time pattern of the user's benefit.

d) If the lessor offers variable lease payments based on market conditions.

35. Mr. Johnson, a lessee, enters into an operating lease agreement for a commercial property with Realty Leasing. The lease term is 12 years. According to AS 19, what is the primary consideration for Mr. Johnson in determining the recognition of lease payments?

a) The lessor's accounting policies for operating leases.

b) The fair value of the leased property.

c) The time pattern of user's benefit.

d) Mr. Johnson's preferred method of accounting.

36. ABC Leasing, as a lessor, leases machinery to XYZ Corporation. According to AS 19, how should ABC Leasing recognize depreciation in its books for the leased machinery if it leases the machine on finance lease?

a) Depreciate the leased machinery based on the lessee's depreciation policy.

b) Recognize depreciation on a straight-line basis over the lease term, irrespective of the lessor's normal depreciation policy.

c) Apply the lessor's normal depreciation policy for similar assets consistently, as stated in AS 10.

d) Lessor cannot book depreciation in his books in case of leased asset.

37. ABC Corporation, as a seller-lessee, enters into a sale and leaseback transaction resulting in a finance lease. The excess of sales proceeds over the carrying amount of the asset should be deferred. According to AS 19, how should ABC Corporation amortize this excess over the lease term?

a) Amortize the excess evenly over the entire lease term.

b) Amortize the excess in proportion to the depreciation of the leased asset.

c) Amortize the excess based on the fair value of the asset.

d) Amortize the excess only if the lease payments exceed market rates.

38. Lease Term is 5 Years. Initial Direct Cost incurred by lessor is 50,000. Fair Value of Leased Asset is 14,50,000. Annual lease rent is Equal in every year. GRV is 1,00,000 and UGRV is 60,000. Interest Rate Implicit in lease is 10%. Calculate Annual Lease Rent Amount.

(a) 3,50,000

(b) 3,69,560

(c) 3,95,778

(d) 3,79,393

39. Lease Term is 3 years. Annual Lease Rent is 5,00,000. GRV is 2,00,000 and UGRV is 1,00,000. Fair Value of Lease Asset is 15,00,00 and initial direct cost is 50,000. What should be the approx interest rate implicit in lease?

(a) 8.23%

(b) 10%

(c) 7.63%

(d) 7.23%

Correct Answer											
Q11	Q12	Q13	Q14	Q15	Q16	Q17	Q18	Q19	Q20	Q21	Q22
a	b	b	a	b	a	c	d	a	c	d	d
Q23	Q24	Q25	Q26	Q27	Q28	Q29	Q30	Q31	Q32	Q33	Q34
b	a	b	c	a	b	d	a	c	a	b	C
Q35	Q36	Q37	Q38	Q39							
c	d	b	b	d							

Student Notes:-

CA NOTES COMMUNITY NETWORK

Click on Icon	QR CODE	LINK
Join what's App group		CLICK HERE
Join Telegram Channel		CLICK HERE
Subscribe On Youtube		CLICK HERE
Follow us On Instagram		CLICK HERE

BE A PART OF CNC FAMILY

CNC – CA NOTES COMMUNITY

Mail at (for complaints/feedback) – canotescommunity@gmai.com

8 ACCOUNTING STANDARD – 26 INTANGIBLE ASSETS

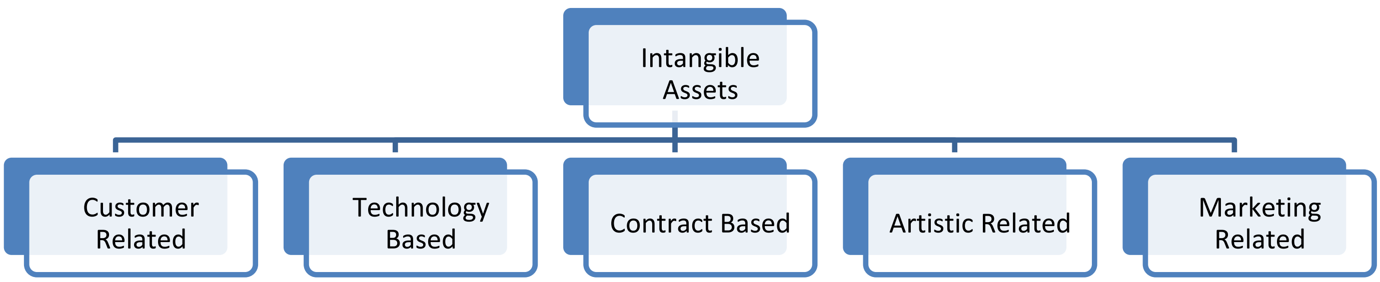
1. MEANING of an ASSET

- Any Resource which is Controlled by the enterprise as a result of past events and,
- From which Future Economic Benefits are expected to flow to the enterprise.

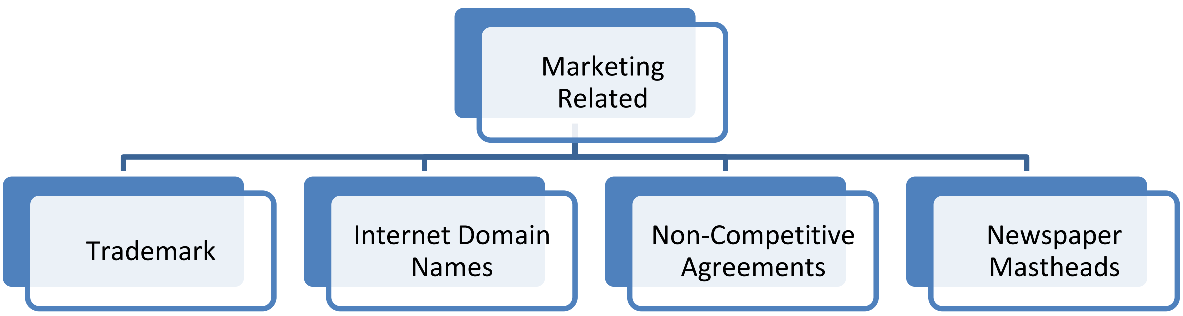
2. MEANING OF INTANGIBLE ASSETS

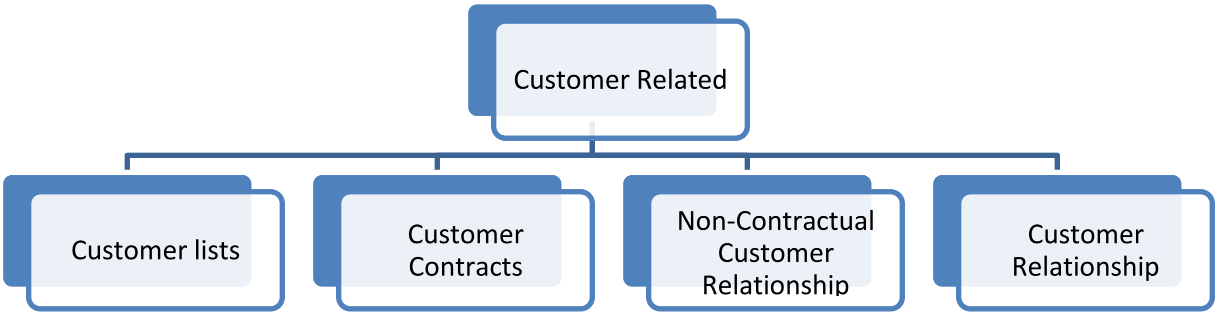
An Intangible asset is an Asset which has following characteristics:

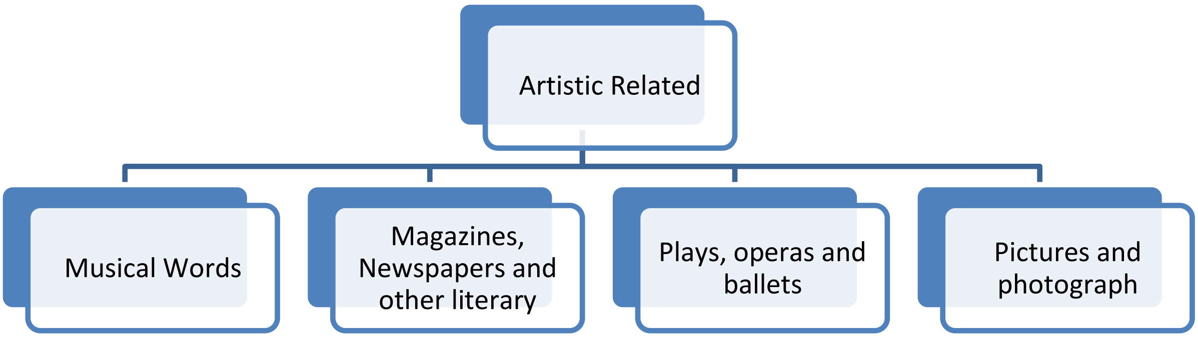
- Identifiable
- Non – Monetary item
- Without physical substance
- Controlled by the entity
- From which future economic benefits are expected to flow
- Held for use in the ordinary course of business.

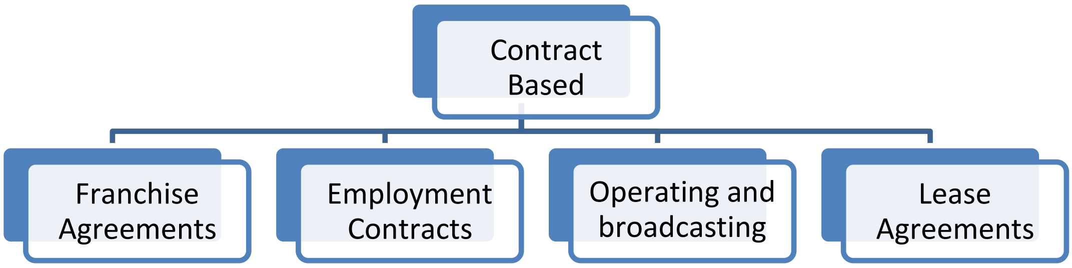


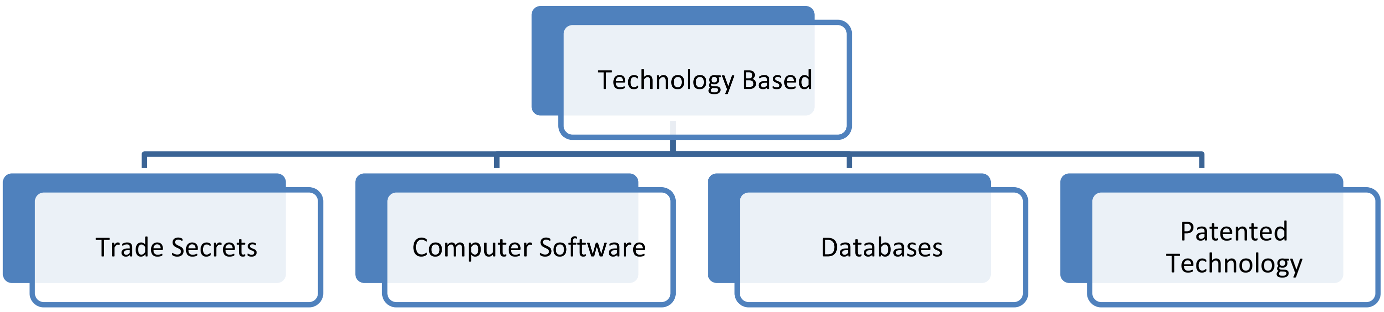
Let's run through some examples of each broad category listed above:











2.1 IDENTIFIABILITY

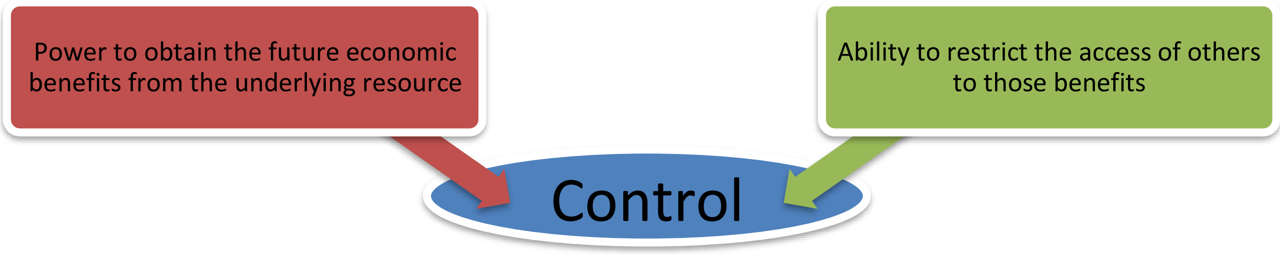
An asset is identifiable if it either:

- is separable, i.e. is capable of being separated or divided from the entity and sold, transferred, licensed, rented or exchanged, either individually or together with a related contract, identifiable asset or liability, regardless of whether the entity intends to do so; or
- arises from contractual or other legal rights, regardless of whether those rights are transferable or separable from the entity or from other rights and obligations.

Author's Note:

Goodwill is not identifiable if it is internally generated. Therefore, this is not an intangible asset within the scope of AS 26

2.2 CONTROL



EXAMPLES ON CONTROL

Example:

Specific management or technical talent is unlikely to meet the definition of an intangible asset, unless it is protected by legal rights to use it and to obtain the future economic benefits expected from it, and it also meets the other parts of the definition.

Example:

Moon Limited has provided training to its staff on various new topics like GST, AS, Ind AS etc. to ensure the compliance as per the required law. Can the company recognise such cost of staff training as intangible asset?

In this case, it is clear that the company will obtain the economic benefits from the work performed by the staff as it increases their efficiency. But it does not have control over them because staff could choose to resign the company at any time. Hence the company lacks the ability to restrict the access of others to those benefits. Therefore, the staff training cost does not meet the definition of an intangible asset.

2.3 FUTURE ECONOMIC BENEFITS

The future economic benefits flowing from an intangible asset may include:

(a) Revenue from the sale of products or services.

(b) Cost savings; or

For clarification, following are not Intangible Assets as per AS 26, hence they should be written off in P&L immediately:

(a) Preliminary expenses (non – identifiable)

(b) Pre-Operating expenses (non – identifiable)

(c) Staff Training

(d) Heavy Advertisement expenses

3. RECOGNITION OF INTANGIBLE ASSETS

If the following conditions are satisfied then, an intangible asset should be recognized/ recorded in the books of accounts, otherwise treated as an expense:

- It is probable that future economic benefits from the intangible asset will flow to the enterprise; and
- The COST of intangible can be measured reliably.

> **Author's Note:**
> Internally generated brands, mastheads, publishing titles, customer lists (if not acquired) and items similar in substance are not recognised as intangible assets.

4. MEASUREMENT OF COST AT INITIAL RECOGNITION

INITIAL MEASURMENT

Intangible Assets should be recognized only at COST.

Case - 1

If Separately Acquired – Cost will be Purchase price including non-refundable duties and taxes and any other directly attributable cost (DAC) of preparing the asset for its intended use.

- Cost of Employee Benefits,
- Professional & Legal Fees,
- Cost of Testing

Cost Excludes: Cost of introducing a new product or brand or service including advertising and promotional activities, Cost of conducting business in a new location or with a new class of customers, Administration and General overhead costs.

Example 4: - Separate Acquisition

Jupiter Ltd acquires new energy efficient technology that will significantly reduce its energy costs for manufacturing.

	Costs incurred include	Cost to be capitalized as per Ind AS 38
Cost of new solar technology	10,00,000	10,00,000
Trade discount provided	(1,00,000)	(1,00,000)
Training course for staff in new technology	50,000	-
Initial testing of new technology	35,000	35,000
Losses incurred while other parts of plant shut down during testing and	25,000	-

	training			
	Total	**10,10,000**	**9,35,000**	

Case - 2

If payment is deferred beyond normal credit terms:

Cost of Intangible Asset is the CASH PRICE EQUIVALENT at the recognition date.

Remaining Amount is Interest which is Total payment - Cash price equivalent.

Case - 3

Acquired through Acquisition/Amalgamation:

In accordance with AS 14, Amalgamation, if an intangible asset is acquired in an acquisition of any company, the cost of that intangible asset is its fair value at the acquisition date.

Case - 4

Exchange of Assets:

Intangible Assets acquired in Exchange for a Non-monetary Asset or Assets or a combination of Monetary and Non-monetary Assets:

Cost of Intangible Asset is **measured at fair value of Asset Given (1st Priority) or Asset Received (2nd Priority) unless:**

- **(i)** Exchange transaction lacks commercial substance; Or
- **(ii)** Fair value of neither the asset(s) received nor the asset(s) given up is reliably measurable.

If the PPE acquired is not measured at Fair Value, its cost is measured at the carrying amount of the asset given up.

Example:

Sun Ltd. Having Telecommunication License with Book Value of 5,00,000, Acquired Software.

Earth Ltd. Having Software with Book Value of 10,000, Acquired Telecommunication License.

Fair Value of Telecom License is 5,00,000 and Software is 5,20,000

Situation 1: Both FV are given. Assuming FV of assets given is more reliable.

In the Books of Sun Ltd.

Software A/c	Dr.	5,00,000	
To Telecommunication License A/c			5,00,000

In the Books of Earth Ltd.

Telecommunication License A/c	Dr.	5,20,000	
To Software A/c			10,000
To Gain on Exchange of Asset A/c			5,10,000

Situation 2: FV of Telecommunication License is 4,90,000 & FV of Software is not Measurable

In the Books of Sun Ltd.

Software A/c	Dr.	4,90,000	
Loss on Exchange of Asset A/c (P&L)	Dr.	10,000	
To Telecommunication License A/c			5,00,000

(FV of Telecommunication License given is taken)		

In the Books of Earth Ltd.

Telecommunication License A/c Dr.	4,90,000	
To Software A/c		10,000
To Gain on Exchange of Asset		4,80,000
(FV of Asset (Telecommunication License) is taken because Asset given FV is not available)		

Situation 3: Both FV are not reliable take BV of assets given

In the Books of Sun Ltd.

Software A/c Dr.	5,00,000	
To Telecommunication License A/c		5,00,000

In the Books of Earth Ltd.

Telecommunication License A/c Dr.	10,000	
To Software A/c		10,000

Case - 5

Acquisition by way of Govt. Grants –

In accordance with AS 12, Accounting for Government Grants, an entity should recognise both the intangible asset and the grant initially at Nominal Value

Example:

Government transfers or allocates to an entity intangible assets such as **airport landing rights**, **licences to operate radio or television stations, import licences or quotas or rights to access other restricted resources.**

Case - 6

Internally Generated Goodwill – Cost cannot be measured reliably hence, not recognized.

Case - 7

Internally generated Intangible assets – like Brands, Customer Lists; Good and Trained employees should not be recognized as intangible assets. Publishing Titles such as "India Today", "Champak" cannot be recorded as IA. (Cost can-not be measured reliably).

5. MEASUREMENT OF EXPENDITURE ON RESEARCH & DEVELOPMENT

(a) Research is original and planned investigation undertaken with the prospect of gaining new scientific or technical knowledge and understanding i.e. Gaining of scientific or technical knowledge.

- Cost of Research activity should not be capitalized as an intangible asset, it should be treated as expense and transfer to P&L a/c as par AS 26.
- Here Entity cannot prove that an intangible asset exists that will generate probable future economic benefits. Therefore, this expenditure is recognised as an expense when it is incurred.

Examples of research activities are:

a) Activities aimed at obtaining new knowledge;

b) The search for, evaluation and final selection of, applications of research findings or other knowledge;

c) The search for alternatives for materials, devices, products, processes, systems or services; and

d) The formulation, design, evaluation and final selection of possible alternatives for new or improved materials, devices, products, processes, systems or services.

(b) Development: It is the activity which converts the result of the research to a marketable product (Gained knowledge is applied).

An intangible asset arising from development (or from the development phase of an internal project) should be recognised if, and only if, an entity can demonstrate all of the following:

1. Technical feasibility of completion of Intangible asset to make it available for use or sale
2. Intention to complete the intangible asset and use or sell it
3. Ability to use or sell the intangible asset.
4. How the intangible asset will generate probable future economic benefits. Among other things, the entity can demonstrate the existence of a market for the output of the intangible asset or the intangible asset itself or, if it is to be used internally, the usefulness of the intangible asset.
5. Adequate resources (like technical, financial or others) to complete the development.
6. Ability to measure reliably the expenditure attributable to the intangible asset during its development.
7. Cost of Development Phase or Internally Generated Intangible Assets comprises all directly attributable costs necessary to create, produce, and prepare the asset to be capable of operating in the manner intended by management.

Examples of directly attributable costs are:

- Cost of materials and services used or consumed in generating the intangible assets.
- Costs of employee benefits arising from the generation of the intangible assets
- Fees to register a legal rights

6. SUBSEQUENT EXPENDITURE

Subsequent Expenditure on already recognized Intangible Asset should be capitalized if the following two conditions are fulfilled:

1. Subsequent Expense increases the future economic benefits of Intangible Assets.
2. Such expense can be measured reliably.

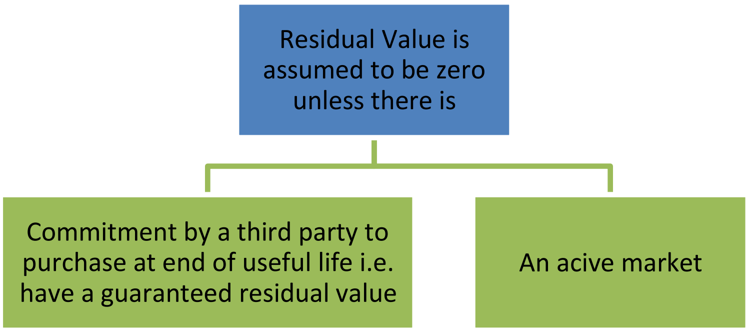
If the above two conditions are not fulfilled than the subsequent expense should be transferred to P&L A/c.

7. AMORTIZATION OF INTANGIBLE ASSET

Amortisation Means	Allocation of the depreciable amount of an intangible asset with a finite useful life on a systematic basis over its useful life
Amortised Period	• The useful life of Intangible Asset is required to estimated based on best available evidence. • There is a rebuttable presumption that the useful life of an intangible asset will not exceed the Ten Years from the date when the asset is available for use unless there is significant evidence that the useful life is more than 10 years. • Factors to be considered to estimate the useful life: ➢ Expected usage ➢ Product Life cycle ➢ Technical or Technological obsolescence ➢ Industry's Stability ➢ Level of Maintenance Expenses incurred during the year ➢ Contractual Conditions • <u>Examples of Useful life more than 10 year through Contract:</u> Franchise License for 20 Years Telecom License for 30 Years License to operate Toll Roads for 25 Years
Amortisation begins and Ends	• Amortisation starts when Asset is Available for Use • Amortisation ends earlier of the date: ➢ When asset is held for sale; or ➢ When asset is derecognized
Amortisation Method	Intangible Asset should be amortised on the following basis: ➢ In proportion of Expected Economic Benefits (1st Priority) ➢ On SLM basis
Review of Amortisation Period and Method	• The amortization period and method should be reviewed at least at each financial year end. • If there is change in amortisation period or method, it is treated as Change in Accounting Estimate.

8. RESIDUAL VALUE

The residual value of intangibles should be assumed to be Zero unless:



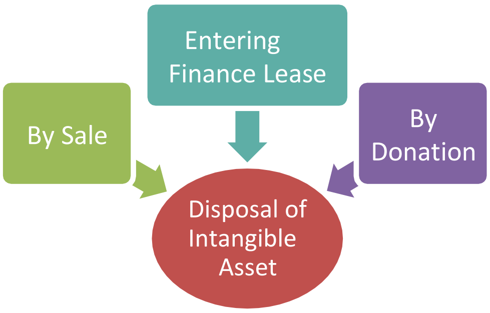
9. RETIREMENT AND DISPOSAL OF INTANGIBLE ASSETS

An intangible asset should be derecognized (eliminated from the Balance sheet) if:

- It is disposed; or
- No future economic benefits are expected from its use.

Gain/Loss arising on retirement or disposal of intangibles should be recognized as income or expense in P&L A/c.

The disposal of an intangible asset may occur in a variety of ways (e.g. by sale, by entering into a finance lease, or by donation).



SOME IMPORTANT POINTS

1. Acquired Customer list may be recognized as Intangible Asset if entity expects to derive benefit from the information on the list for at least one year.

2. The product protected by the patented technology is expected to be a source of net cash inflows for at least 15 years. The entity has a commitment from a third party to purchase that patent in five years for 60 per cent of the fair value of the patent and the entity intends to sell the patent in five years.
   The patent would be amortised over its five-year useful life to the entity, with a residual value equal to the present value of 60 per cent of the patent's fair value at the date it was acquired.

3. Intangible Assets should be amortised based on the useful life instead of the legal life (if legal life is different).

4. Assets that incorporate both Tangible & Intangible elements should be treated as under:
   The entity uses judgement to assess which element is more significant i.e. "Which one is more dominating?"
   For example, computer software for a computer-controlled machine tool that cannot operate without that specific software is an integral part of the related hardware and it is treated as property, plant and equipment. The same applies to the operating system of a computer.
   When the software is not an integral part of the related hardware, computer software is treated as an intangible asset.

10. MCQ's from ICAI Resources

1. Which of the following is not covered within the scope of AS 26?
   (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

2. Intangible asset is recognised if it:
   (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

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:
   (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.

4. Hexa Ltd developed a technology to enhance the battery life of mobile devices. Hexa has capitalised development expenditure of ₹ 5,00,000. Hexa 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?
   (a) ₹ 2,50,000
   (b) ₹ 1,75,000
   (c) ₹ 1,66,667
   (d) ₹ 1,85,000

5. Which of the following expense can be capitalized as per AS 26?
   (a) expenditure on Major advertising
   (b) Expenditure on an intangible item that was initially recognised as an expense in the previous Financial year
   (c) expenditure on training activities of new license acquired
   (d) Subsequent expenditure on Intangible asset which will enhance future benefit expenditure that can be measured reliably

6. AS 26 is applicable to following:
   (a) Deferred tax assets
   (b) Rights under licensing agreements for films

(c) Financial Assets

(d) Goodwill arising on an amalgamation

ANSWERS	1	2	3	4	5	6
	c	d	a	b	d	b

11. MCQ's Created by Jai Sir & Team

7. Which of the following is correct?

   a) AS 26 applies to mineral rights and expenditure on the exploration for, or development and extraction of, minerals, oil, natural gas and similar non-regenerative resources.

   b) AS 26 applies to intangible assets arising in insurance enterprises from contracts with policyholders.

   c) AS 26 applies to intangible assets that are covered by another Accounting Standard.

   d) None of the above.

8. What is an impairment loss?

   (a) The amount by which the carrying amount of an asset exceeds its recoverable amount

   (b) The amount by which the carrying amount of an asset equals its recoverable amount

   (c) The amount by which the carrying amount of an asset is less than its recoverable amount

   (d) The amount by which the carrying amount of an asset is equal to its fair value

9. Company X invests ₹500,000 in an internal project aimed at developing a new software program. However, it is unable to distinguish between the research and development phases of the project. How should Company X treat the expenditure according to the provided data?

   (a) Treat the entire expenditure as incurred in the development phase only

   (b) Treat the entire expenditure as incurred in the research phase only

   (c) Allocate the expenditure equally between the research and development phases

   (d) Cease the project until the phases can be distinguished

10. Company A spends ₹300,000 on research activities aimed at developing a new pharmaceutical drug. According to the provided data, how should Company A treat this expenditure?

   (a) Recognize it as an intangible asset

   (b) Recognize it as an expense when incurred

   (c) Capitalize it as part of development costs

   (d) Allocate it evenly between research and development phases

11. Company Z is developing a new marketing strategy. It has demonstrated technical feasibility and has the intention to complete the project. However, there is uncertainty about the availability of

financial resources to complete the development. Should Company Z recognize an intangible asset for this project?

(a) Yes, because technical feasibility and intention to complete the project have been demonstrated

(b) Yes, because the project has demonstrated its ability to generate future economic benefits

(c) No, because there is uncertainty about the availability of financial resources to complete the project.

(d) No, because the marketing strategy is not yet available for use or sale

12. Company X incurs ₹50,000 on purchasing materials and services for developing a new software program. Additionally, it pays ₹80,000 in salaries, wages, and other employment-related costs for personnel directly engaged in the development. If the overhead costs allocated to the software project amount to ₹20,000 and expenditure on training the staff to use the internally generated software amount to ₹50,000, what is the total cost of internally generating the software?

(a) ₹100,000

(b) ₹150,000

(c) ₹130,000

(d) ₹200,000

Correct Answer					
Q7	Q8	Q9	Q10	Q11	Q12
D	a	b	b	c	b

Student Notes:-

9 ACCOUNTING STANDARD – 28 IMPAIRMENT OF ASSETS

IMPARIMENT means Reduction in the value of Assets due to external or internal indicators such as change in technology, physical damage etc.

1. APPLICABABILITY AND NON - APPLICABILITY:

A. AS 28 is applicable to:

1. PPE (AS 10)
2. Intangible Assets (AS 26)
3. Investment Property (AS 13)
4. Goodwill Acquired in Amalgamation & Consolidation (AS 14 & 21)

B. AS 28 is Not Applicable to:

1. Inventories (AS 2)
2. Assets arising under Construction Contract (AS 7)
3. Deferred tax assets (AS 22)
4. Financial Assets such as investment in shares, debentures, bonds & securities (AS 13)
5. Any Current Asset

2. INDICATIONS OF IMPAIRMENT

A. External indicators for Impairment of Asset: (List is not exhaustive or conclusive)

- **a)** Asset's market value has declined significantly more than would be expected as a result of the passage of time or normal use.;
- **b)** Significant changes with an adverse effect on the entity have taken place due to change in technology, market, economy or legal environment.
- **c)** Market interest rates have increased during the period, and those increases are likely to affect the discount rate; and
- **d)** Book Value of Net Assets is more than Market Value Net Assets.

B. Internal source of information: (List is not exhaustive or conclusive)

- **a)** Obsolescence or Physical damage of an asset;
- **b)** Asset becoming idle, plans to dispose of an asset before the previously expected date, and reassessing the useful life of an asset as finite rather than indefinite;

c) Plans to discontinue or restructure the operation to which an asset belongs,
d) Economic performance of an asset is, or will be, worse than expected.

3. IDENTIFYING AN ASSET THAT MAY BE IMPAIRED

Asset is impaired only when Carrying Amount is more than Recoverable Amount.

CA – RA = IMPAIRMENT LOSS

1) **Carrying Amount –** Book value of Asset at the end of the relevant year after charging Depreciation.
2) **Recoverable Amount –** Higher of:
   a) **Net Selling Price (NSP) –** if asset is sold immediately then how much net proceeds would be realised.
   b) **Value in Use –** if asset is further used then present value of future cash flows to be realised.

4. MEASUREMENT OF RECOVERABLE AMOUNT

Recoverable Amount	Higher of "Net Selling Price" and "Value in use"
Net Selling Price (NSP)	Net Selling Price is the amount obtainable from sale of Asset in an Arm's Length transaction (i.e. Fair Value) less cost to sell.
Cost to Sell	Legal costs, stamp duty and similar transaction taxes, costs of removing the asset, and direct incremental costs to bring an asset into condition for its sale. But Employees termination benefits are not cost to sell.
Value in use (VIU)	Present value of the future cash flows expected to be derived from use of an asset including disposal at the end of useful life.
Discounting Rate for VIU	• Pre-tax discount rate should be used. • Discount rate can be either weighted avg. cost of capital or entity's incremental borrowing rate.
Estimating Future Cash Flows for VIU	• Reasonable and supportable assumptions should be considered • Projections should cover a maximum of 5 years unless longer period can be justified. • Future Cash Flows should not include: ➢ Cash inflows from receivables ➢ Cash outflows from payables ➢ Cash flows of future restructuring (including Business acquisitions to which entity is not yet committed ➢ Cash flows expected from improving or enhancing the asset's performance ➢ Income tax receipts/payments

Foreign Currency Future Cash Flows (Apply AS 11 Also) (Refer Example 1)	Step 1: FC Cash flows × Discount Rate relating to country of foreign currency Step 2: Translate Discounted cash flows using exchange rate on the date of measurement of Value in Use.

Note:

1) If NSP is not determinable, then value in use is considered as Recoverable Amount
2) If VIU is not determinable, then Recoverable amount of such asset can-not be determined. In Such case Impairment of CGU shall be done.

Example 1:

Entity has estimated following cash flows in foreign currency:

Year	Cash flows ($)
1	1,00,000$
2	1,50,000$
3	1,35,000$

Discount Rate	
Related to ₹	Related to $
10%	4%

$1 = ₹ 83/- as the date of measurement of Value in Use. Calculate Value in Use in Rupees.

Answer:

Apply discounting rate of 4% to the cash flows = $3,54,852

PV of foreign cash flows in Rupees i.e. Value in Use = $ 3,54,852 × 83 = Rs. 29,452,716

5. IMPAIRMENT OF INDIVIDUAL ASSET

Steps to be followed for calculation and treatment of Impairment loss:

Step 1: Calculate Carrying Amount of Asset as on Balance Sheet (After charging depreciation)

Step 2: Calculate Recoverable Amount of Asset

Step 3: If Carrying Amount is higher than Recoverable Amount then difference is Impairment Loss

Step 4: Treatment of Impairment loss as under:

- If Asset belongs to Cost Model – Charge the Impairment loss to P&L A/c
- If Asset belongs to Revaluation Model – Charge the impairment loss to revaluation surplus if available and remaining loss to P&L A/c

Step 5: Calculate Revised Carrying Amount of Asset after Impairment for the purpose of further depreciation in future. (CA before impairment – Impairment loss)

Journal Entry for Impairment Loss:	
Impairment Loss A/c Dr. To Asset A/c	Revaluation Surplus A/c Dr. (1st Priority) Profit and Loss A/c Dr. (Balancing Fig.) To Impairment Loss A/c

Important Note:

1. If impairment loss is more than carrying amount of asset, then liability should be recognised after writing off the carrying amount.
2. Since impairment loss is not deductible under income tax, Hence Accounting Income will be lower than Taxable Income, Deferred Tax affect should be calculated after impairment. DTA shall be created on Impairment loss. (will be covered in AS 22)

6. IMPAIRMENT LOSS OF A CASH-GENERATING UNIT (CGU) INLUDING GOODWILL & CORPORATE ASSET

A cash-generating unit is the smallest identifiable group of assets that generates cash inflows that are largely independent of the cash inflows from other assets or groups of assets.

- Always try to impair Individual Asset first for which indication of impairment exist and estimate the recoverable amount of that individual asset.
- If it is not possible to estimate the recoverable amount of the individual asset, then recoverable amount of the cash-generating unit to which the asset belongs should be determined and apply impairment testing of CGU.
- CGU may include current assets, goodwill, corporate assets and liabilities also.
- Only those Assets and Liabilities should be considered in carrying amount of CGU which are taken into account for determining Recoverable Amount (i.e. basis should be same)
- Examples of liabilities that can become part of CGU – Provision for decommissioning liabilities, specific loans taken for CGU Assets.

Example 2:

A company manufactures a flavored drink from Machine A and the drink can be sold only in bottles for which machine B is to be used. Here both machines can-not generate cash flows individually hance they shall be clubbed together to form a CGU.

More Examples – Magazine Titles, Buses running in a different route

Carrying Amount of CGU:	Carrying Amount of PPEs of CGU (+) Carrying Amount of Intangible Assets of CGU (+) Carrying Amount of Current Assets of CGU (+) Carrying Amount of Goodwill allocated to CGU (+) Carrying Amount of Corporate Assets allocated to CGU
Corporate Assets:	Assets other than goodwill that helps CGU under review and other CGUs to generate Independent Cash Flows. (For Ex. Head office buildings)
How to Impair Goodwill and Corporate Assets	Goodwill and Corporate Assets doesn't generate independent cash flows hence they can-not be tested for impairment individually. Goodwill & Corporate Assets are first allocated to different CGUs on a Reasonable basis and then they are tested for impairment.
How to allocate Goodwill and Corporate Assets?	Goodwill shall be allocated either in the ratio given in the question (or) in the ratio of Fair Values of CGUs at the time of business acquisition. Corporate Assets shall be allocated either in the ratio given in the question (or) in the ratio of following amounts of each CGU: Carrying Amt. x Useful life (if useful life is not given then only carrying amount of CGUs can be used to find out ratio)
Un-allocable Goodwill and Corporate Assets	Apply Bottom-up approach for Goodwill and Corporate Assets which are Allocable to CGUs. Apply Top-down approach for Goodwill and Corporate Assets which are not allocable to CGUs.
Important Note	Impairment Loss is never allocated to Current Assets or any other assets on which AS 28 is not applicable

Steps to Solve the Complete Question:

Approach	Particulars	CGU 1	CGU 2	CGU 3	Total
Bottom Up	Carrying Amt of CGUs	XXX	XXX	XXX	XXXX
	(+) Allocate Goodwill	XXX	XXX	XXX	XXXX
	(+) Allocate Corporate Assets	XXX	XXX	XXX	XXXX
	Total Carrying Amount of CGUs	XXX	XXX	XXX	XXXX
	Less:				
	Total Recoverable Amt. of CGUs	XXX	XXX	XXX	XXXX
Bottom up continued	Impairment Loss of CGUs	XXX	XXX	XXX	XXX
	(-) Allocable Goodwill (1st Priority)	XX	XX	XX	XX

	(-) Remaining Imp. Loss is allocated to all other Assets including Corporate Assets in the given ratio	XXX	XXX	XXX	XXX
Top-down	Revised Carrying Amt. of CGUs (+) Un-allocable Goodwill or Corporate Assets Total Carrying Amount of Entity as a whole (-) Recoverable Amt. of Entity as a whole	XXX -	XXX -	XXX -	XXX XXX XXX XXX
Top-down	Additional Impairment Loss for Un-allocable Goodwill and Corporate Assets only (Do not impair CGUs since they are already tested for impairment)				XXX

Example 3:

A CGU Consist of three Assets A. B C, having total Recoverable Amount of Rs. 25,00,000 and Carrying Amount are as under:

	Carrying Amt.
A	1,00,000
B	8,00,000
C	10,00,000

Calculation of Impairment Loss	
CA Of CGU	300000
(-) RA OF CGV	2500000
Impairment Loss	**5,00,000**

As per AS 28, Impairment loss of CGU shall be allocated to Individual Assets of CGU in proportion of their respective carrying amounts:

A's Impairment Loss	5,00,000 × 12/30	2,00,000
B's Impairment Loss	5,00,000 × 8/30	1,33,333
C's Impairment Loss	5,00,000 × 10/30	1,66,667

Example 4: (CGU with Goodwill)

A Ltd. took over subsidiary B Ltd. which has four CGUs whose Fair value are as under:-

CGUs (Factories)	Fair Values
1	80 lacs
2	70 lacs
3	90 lacs
4	60 lacs

Total Fair Value	300 lacs
Purchase Consideration is 320 lacs	

After Two years, CGU 2 has indicated Impairment. CGU 2 has three Assets with following Carrying Amounts as under:

A – 30 Lacs; B – 25 Lacs and C – 60 Lacs and Recoverable Amount of CGU 2 is 105 Lacs.

Required:

1. Calculate Goodwill and Annual Amortisation
2. Calculate Impairment loss of CGU 2 if goodwill is allocated in proportion of Fair Values
3. Allocate Impairment Loss to different Assets.

Solution:

Calculation of Goodwill and Amortisation thereon

Purchase Consideration discharged	320 Lacs
Less: Fair Value of Business Acquired	300 Lacs
Goodwill	**20 lacs**
Goodwill amortisation	5 years
Annual Amortisation	4 Lacs
Carrying Amount of Goodwill After 3 years	8 Lacs

Note: When there is a Goodwill, entity can-not impair any CGU without Goodwill. Also, Goodwill can never be Impaired individually.

Calculation of Impairment Loss of CGU 2

Carrying Amount of CGU 2	
Asset A	30 Lacs
Asset B	25 Lacs
Asset C	60 Lacs
	115 Lacs
Add: Allocated Goodwill (8 x 70/300) (Allocation in ratio of Fair Values of CGUs)	1.87 Lacs
Total Carrying Amount with Goodwill	**116.87 Lacs**
Recoverable Amount of CGU2	105 Lacs
Impairment loss of CGU2	11.87 lacs
(-) Goodwill w/f (First Priority)	1.87 lacs
Remaining Impairment Loss for A, B & C	**10 lacs**

Allocation of Impairment Loss to A, B and C in ratio of their respective carrying amounts:

A	10×30/115	2.60 lacs
B	10× 25/115	2.17 lacs
c	10×60/115	5.23 lacs
	Total Loss	**10 Lacs**

Example 5: (CGUs, Goodwill and Corporate Asset)

An entity has 3 CGUS consisting of following Assets

Asset	CA	
A	3,00,000	CGU-1
B	5,00,000	CGU-3
C	10,00,000	CGU-2
D	6,00,000	CGU-1
E	1,50,000	CGU-2
F	7,50,000	CGU-3
G	80,000	CGU-1
H	2,50,000	CGU-3

There is Goodwill of Rs. 2,70,000/- that belongs all CGUs in the ratio of 2:3:4

	CGU 1	CGU 2	CGU 3
Recoverable Amount	10,00,000	9,00,000	16,50,000

Calculate Impairment Loss of CGUS

Solutions:

1) **Allocation of Assets to CGU**

Particular	CGU 1	CGU 2	CGU 3
A	3,00,000	-	-
B	-	-	5,00,000
C	-	10,00,000	
D	6,00,000	-	-
E	-	1,50,000	-
F	-	-	7,50,000
G	80,000	-	-
H	-	-	2,50,000
Total CA excluding Goodwill	**9,80,000**	**1,15,000**	**15,00,000**
(+) Goodwill allocation 2:3:4	60,000	90,000	1,20,000
Total CA	**10,40,000**	**12,40,000**	**16,20,000**

2) **Impairment Testing**

Particular	CGU 1	CGU 2	CGU 3
CA of CGU	10,40,000	12,40,000	16,20,000
RA of CGU	10,00,000	9,00,000	16,50,000
Impairment loss	**40,000**	**3,40,000**	**-**

3) **Allocation of Impairment Loss**

(a) CGU 1

Impairment Loss	40,000
(-) Goodwill	40,000
	0

(b) CGU2

Impairment Loss	3,40,000
(-) allocated G/w	90,000
Remaining Impairment Loss	2,50,000
Imp. Loss for Asset C	2,50,000 × 20/23 = **2,17,391**
Imp. Loss for Asset E	2,50,000 × 3/23 = **32,609**

<u>Example 6:</u> (Bottom up and Top-Down Approach)

At the end of 20X0, enterprise M acquired 100% of enterprise Z for ₹ 3,000 lakhs. Z has 3 cash-generating units A, B and C with net fair values of ₹ 1,200 lakhs, ₹ 800 lakhs and₹ 400 lakhs respectively. M recognises goodwill of ₹ 600 lakhs (₹ 3,000 lakhs less ₹ 2,400 lakhs) that relates to Z. At the end of 20X4, A makes significant losses. Its recoverable amount is estimated to be ₹ 1,350 lakhs. Carrying amounts are detailed below (₹ In Lakh)

End of 20X4	A	B	C	Goodwill	Total
Net carrying amount	1300	1200	800	120	3420

Scenario A - Goodwill Can be Allocated on a Reasonable and Consistent Basis

On the date of acquisition of Z, the net fair values of A, B and C are considered a reasonable basis for a pro-rata allocation of the goodwill to A, B and C.

Allocation of goodwill at the end of 20X4:

	A	B	C	Goodwill
End of 20×0				
Net fair values	1200	800	400	2400
Pro-Rata	50%	33%	17%	100%
End of 20×4				
Net carrying amount	1300	1200	800	3300
Allocation of goodwill	60	40	20	120
(Using pro rate above)				
Net carrying amount (After goodwill)	1360	1240	820	3420

In accordance with the 'bottom-up' test in paragraph 78(a) of AS 28, M compares A's recoverable amount to its carrying amount after the allocation of the carrying amount of goodwill:

End of 20X4	A (Rs. In Lakh)
Carrying amount after allocation of goodwill	1360
Recoverable amount	1350
Impairment loss	10

M recognises an impairment loss of ₹ 10 lakhs for A. The impairment loss is fully allocated to the goodwill in accordance with paragraph 87 of AS 28.

Scenario B - Goodwill Cannot be Allocated on a Reasonable and Consistent Basis

There is no reasonable way to allocate the goodwill that arose on the acquisition of Z to A, B and C. At the end of 20X4, Z's recoverable amount is estimated to be ₹3,400 lakhs.

At the end of 20X4, M first applies the 'bottom-up' test in accordance with paragraph 78(a) of this Statement. It compares A's recoverable amount to its carrying amount excluding the goodwill.

End of 20X4	A (Rs. In Lakh)
Carrying amount	1300
Recoverable amount	1350
Impairment loss	0

Therefore, no impairment loss is recognised for A as a result of the 'bottom-up' test.

Since the goodwill could not be allocated on a reasonable and consistent basis to A, M also performs a 'top-down' test in accordance with paragraph 78(b) of AS 28. It compares the carrying amount of Z as a whole to its recoverable amount (Z as a whole is the smallest cash-generating unit that includes A and to which goodwill can be allocated on a reasonable and consistent basis)

Application of the 'top-down' test (Amount in ₹ lakhs)

End of 20X4	A	B	C	Goodwill	Total
Carrying amount	1300	1200	800	120	3420
Impairment loss arising from the 'bottom-up' test	-	-	-	-	0
Carrying amount after the 'bottom-up' test	1300	1200	800	120	3420
Recoverable amount	-	-	-	-	3400
Impairment loss arising from 'topdown' test	-	-	-	-	20

Therefore, M recognises an impairment loss of ₹ 20 lakhs that it allocates fully to goodwill in accordance with AS 28.

7. REVERSAL OF IMPIRMENT LOSS

Indicators of reversal of Impairment Loss:

External –

- Asset's value has increased significantly during the period.
- Significant changes with an favorable effect on the entity have taken place due to change in technology, market, economy or legal environment.
- Market interest rates have decreased during the period, and those increases are likely to affect the discount rate; and

Internal –

- Asset's performance has been significantly improved. It may be because of Cost incurred to improve or enhance the performance or Cost incurred to restructure the operation during the period.
- Economic performance of the asset is, or will be, better than expected.

Goodwill:

An impairment loss recognised for goodwill shall not be reversed in a subsequent period.

Assets other than Goodwill:

If there is an Indication that shows Impairment Loss recognised earlier may no longer exists or may have decreased, then entity shall revers the impairment loss and accordingly recoverable amount is to be determined.

How to Calculate the Reversal of Impairment Loss:

Step 1: Identity Current Actual Carrying Amount of Asset – assume 1000/-

Step 2: Identity Current Recoverable Amount of Asset – assume 1200/-

Step 3: Calculate Current Carrying Amount of Asset if Asset were never impaired earlier (assume 1150/-)

Step 4: Revised Carrying amount after reversal should be lower of Step 2 & Step 3 (Means 1150/-)

Step 5: Reversal of Impairment Loss = Step 4 – Step 1 (means 1150 – 1000 = 150)

Step 6: Calculate Revised Actual Carrying Amount = Current Carrying Amount before reversal (Step 1) + Reversal of I/L (Step 5)

Note: Depreciation shall be charged on Revised Carrying Amount

(Refer Examples)

Accounting treatment of Reversal of Impairment Loss:

Asset A/c Dr.

To Impairment Loss Reversal A/c

Impairment Loss Reversal A/c Dr.

To Revaluation Surplus A/c (if available & Asset is under Revaluation model)

To Profit and Loss A/c (Balancing Fig.)

Reversal of Impairment Loss of CGU:

A reversal of an impairment loss for a cash-generating unit shall be allocated to the assets of the unit, except for goodwill, in proportion of carrying amounts of those assets.

EXAMPLE 7: (REVERSAL OF IMPAIRMENT OF LOSS)

Cost of Asset purchase on 1/4/2001 is Rs. 10,00,000, Depreciation on SLM basis based on life of 10 years. On 31/3/2005, Recoverable Amount is. 3,00,000.

On 31/3/2007, Recoverable Amount is:

Case 1: RA = 2,20,000

Case 2: RA = 4,20,000.

Calculate Impairment Loss and its Reversal.

Example 8: **(Reversal of Impairment Loss along with revaluation effect)**

As on 1/4/16 Original Cost of PPE = 30,00,000; Estimated Life = 12 years; Depreciation is charged under SLM Method. Therefore, Original Depreciation = 2,50,000 pa.

On 1/4/19, Fair Value of PPE was 27,00,000 (PPE is under Revaluation Model)

Carrying Amt. (CA) as on 1/4/19 = 30,00,000/12 X 9 = 22,50,000

Therefore, Revaluation Surplus = 4,50,000

Revised CA as on 1/4/19 = 27,00,000

Remaining Life = 9 years

Revised Depreciation = 3,00,000 P.a.

Assuming entity opted to transfer partial revaluation surplus to GR equal to excess depreciation i.e. 50,000 p.a.

On 31/3/21, PPE tested for impairment & Recoverable amount is 16,00,000

CA as on 31/3/21	= 21,00,000
Recoverable Amount	= 16,00,000
Impairment Loss	= 5,00,000
Setoff out of Revaluation Surplus	= 3,50,000
Remaining Transfer to P&L	= 1,50,000
Revised CA as on 31/3/21	= 16,00,000
Balance of Revaluation Surplus	= Nil

Depreciation = 2,28,571 (P.A.) with useful life of 7 years

On 31/3/24, Indicators of Reversal of Impairment arise,

Recoverable Amount is: -

Case 1 = 11,00,000

Case 2 = 15,00,000

Current CA (as on 31/3/24) = 9,14,286

Reversal (Case 1)

Recoverable Amt. = 11,00,000

CA had there been no Impairment earlier = 27,00,000/9 X 4 = 12,00,000

Whichever is less, i.e. 11,00,000

CA of PPE should be increased to 11,00,000

Reversal of I/L = 1,85,714 (11,00,000 – 9,14,286)

What could be the revaluation surplus Balance had there been no impairment earlier?

4,50,000/9 X 4 = 2,00,000 (Hence entire reversal shall be made through Revaluation Surplus)

PPE A/c	Dr.	1,85,714	
To Revaluation Surplus			1,85,714

Reversal (Case 2)

Recoverable amount = 15,00,000

CA had there been no Impairment earlier = 12,00,000

Whichever is lower i.e. CA shall be increased to ₹ 12,00,000

Reversal = 2,85,714

Maximum Revaluation Surplus that could be increased (had there been no impairment) = 2,00,000

Profit & Loss = 85,714

PPE A/c Dr.	2,85,714	
To Revaluation Surplus		2,00,000
To P & L A/c		85,714

8. MCQ's from ICAI Material

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:

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.

2) In case Goodwill appears in the Balance Sheet of an entity, the following is true:

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.

3) In case of Corporate assets in the Balance Sheet of an entity, the following is true:

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.

4) In case of reversal of impairment loss, which statement is true:

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.

ANSWERS	1	2	3	4
	b	c	c	c

Student Notes:-

10 ACCOUNTING STANDARD – 5 "NET PROFIT OR LOSS FOR THE PERIOD, PRIOR PERIOD ITEMS & CHANGE IN ACCOUNTING POLICIES"

Quote:

You should never regret anything in life. If it's good, it's wonderful. If it's bad, it is experience.

1. NET PROFIT OR LOSS FOR THE PERIOD:

(1) As per AS-5, all the items of **Incomes & Expenses** which are recognized in a period should be included in the determination of "Net Profit/Loss for the period" **unless** other AS requires/permits otherwise.

Examples:

AS-10: on upward revaluation of FAs, the difference should be transferred to Revaluation reserve a/c

AS-12: Grant received for Depreciable FA should be deducted from the gross book value of concerned asset.

AS-16: Borrowing Cost should be added to the cost of FA.

(2) Net Profit/Loss for the period consist of: Profit/Loss from,

(i) **Ordinary Activities** and

(ii) **Extraordinary Items.**

(i) **Ordinary activities** are any activities which are: -

- Undertaken by the Enterprise
- As a part of its Business

and such related activities in which the enterprise engages in furtherance of, Incidental to, or arising from, these activities e.g., Profit on sale of merchandise, loss on sale of unsold inventory.

What to do with Items of Ordinary Activities - As per AS – 5, when items of incomes and expenses from ordinary activities are of such SIZE or NATURE that their disclosure is relevant to explain the performance of enterprises, then the NATURE and AMOUNT of such item should be separately disclosed in EXCEPTIONAL CATOGERY in the statement of Profit and Loss.

In Simple terms:

(i) Items of Ordinary activities shall either have 'defined headings' separately

(e.g.: revenue from operation, finance cost & Employee Benefit Expenses etc.,)

(ii) If they don't have separate headings and required to be disclosed separately to explain the performance of the entity then such items may be disclosed under 'Exceptional Category'

Author's Notes:

Ordinary Items includes Exceptional Items also and its separate disclosure is relevant to explain the performance of the enterprise.

Some Examples:

a. The write-down of inventories to net realisable value as well as the reversal of such write-downs
b. A restructuring of the activities of an enterprise and the reversal of any provisions for the costs of restructuring
c. Disposals of items of fixed assets
d. Disposals of long - term investments
e. Legislative changes having retrospective application
f. Litigation settlements
g. Other reversals of provisions

(ii) Extraordinary items are: -

- Incomes and expenses **(Not Assets & Liabilities)**
- Arise from events or transactions
- Which are clearly **distinct** from ordinary activities
- And are not expected to recur **frequently** or regularly.

What to do with Extraordinary Items - As per AS – 5, **Nature** and **Amount** of extraordinary items should be separately disclosed in the statement of profit and loss in a manner that its impact on current profit or loss can be Interpreted.

Examples of Extraordinary items: - Loss due to Earthquake/Fire, Refund of Govt. Grant, VRS expenditure.

2. PRIOR PERIOD ITEMS ARE:

Prior Period items means the items of:

1. Incomes and Expenses **(Not Assets & Liabilities)**
2. Which arise in Current period
3. As a result of **Error or Omission** in the preparation of F/s of one or more Prior Periods.

As per AS – 5, the Nature & Amount of Prior period items should be separately disclosed in Notes to Accounts so that their impact on current year's profit/loss can be seen.

Examples of Prior Period Items:

(a) Omission to account for Incomes or Expenses
(b) Non provision for salary already due in earlier years.
(c) Applying incorrect rate of Depreciation.
(d) Treating Operating lease as Finance lease.

Case Scenario Example:

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

Solution

No, the company is not correct in treating the amount written off as a prior period item. As per AS 5, prior period items are income or expenses which arise in a current year due to errors or omissions in the preparation of the financial statements of one or more prior period(s).
Writing off an old outstanding balance in the current year which is appearing in its books of accounts from the past 5 financial years does not mean that there has been an error or omission in the preparation of financial statements of prior period(s). It is just a practice adopted by the company to write off the old outstanding balances of more than 5 years in its current year books of accounts. Therefore, the amount written off is not treated as a prior period item.
Hence, adjusting the amount ₹50,000 written off as a prior period item on the basis that sundry balances were recognized in prior period(s) is not in line with AS 5.

3. CHANGES IN ACCOUNTING POLICIES:

Accounting policies can be changed by complying the conditions of AS 1 – Disclosure of Accounting Policies.

Requirements as per AS – 5:

a) **Material effect** of changes in accounting policies should be disclosed in financial statements in the year in which such changes occur.

b) Such material effect should be **ascertained** (i.e., quantified).

c) If it is not ascertainable, the **fact** should be disclosed.

d) If the effect of such change is not material for the current period, but will be material for the **later periods**, then the **fact** should be disclosed in the period of change.

Also as per AS 1 (Disclosure of Accounting Policies), an entity may change its accounting policies when either of following 3 conditions are satisfied:

(i) Change in A/c policy due to change in AS or adoption of any AS requirement

(ii) Such changes is because of change in statue/law or required by law

(iii) Such change is adoption for more appropriate presentation in FS

4. CHANGE IN ACCOUNTING ESTIMATES:

1. As a result of Uncertainties Inherent in business activities, many financial statement items cannot be measured with accuracy, but can only be estimated.
2. The estimation process involves judgments based on the latest information available and circumstances.
3. Estimates may have to be revised, if changes occur regarding the circumstances on which estimate was based, or as a result of new information.
4. As per AS – 5, effects of changes in accounting timates should be classified using the same classification in the statement of profit and loss as was used previously for the estimate.
5. If an estimate pertains to ordinary activity, then change in accounting estimate should be classified as an ordinary activity.
6. If an estimate pertains to extraordinary/exceptional activity, then change in accounting estimate should be classified as extraordinary/exceptional.
7. Changes in a/c estimates shall not be treated as 'Extraordinary item' or 'Prior period item'.
8. Sometimes it is difficult to distinguish between a change in an accounting policy and a change in an accounting estimate. In such cases, the change is treated as a change in an accounting estimate, with appropriate disclosure. (AS – 5)

Note:

1. Change in A/c policy ----- Retrospective effect.
   Change in A/c estimates ----- Prospective effect.
2. Examples of accounting estimates are estimating the residual value of fixed assets, estimating the useful life of fixed assets, provision for doubtful debts and income tax.

5. (MCQ's from ICAI Material)

1. A change in the estimated life of the asset, which necessitates adjustment in the depreciation is an example of
   (a) Prior period item.
   (b) Ordinary item.
   (c) Extraordinary item.
   (d) Change in accounting estimate.

2. Which of the following is considered as an extraordinary item as per AS 5?
   (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.

3. Which one of the following is an example of extraordinary item?
   (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.

4. Extraordinary items are income or expenses
   (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.

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
   (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).

6. Which of the following circumstances may not give rise to the separate disclosure of items of income and expense
   (a) The write-down of inventories to net realisable value
   (b) Legislative changes having retrospective application

(c) Litigation settlements
(d) Separation cost paid to CEO of the company

7. Following is not required to be disclosed separately in the statement of P&L?
(a) Profit or loss from ordinary activities
(b) Profit or loss from extraordinary activities
(c) The nature and amount of prior period items
(d) Impact of change in estimate in the normal course of transaction.

8. Which of the following is a Prior Period item?
(a) Arrears payable to workers as a result of revision of wages with retrospective effect during the current period
(b) Change in the useful life of the asset in current year based on 3 years old technical estimate.
(c) income or expense recognised on the outcome of a contingency which previously could not be estimated reliably
(d) Change in the estimate of the amount of bad debts based on court order in current year

9. Which of the following may not be considered as an extra ordinary iten?
(a) Attachment of property of the enterprise
(b) Losses sustained as a result of an earthquake
(c) Claims from policyholders arising from an earthquake for an insurance enterprise that insures against such risks
(d) Loss due to rmajor fire in an important plant of the cormpany

ANSWERS	1	2	3	4	5	6	7	8	9
	d	d	c	c	d	d	d	b	c

Student Notes: -

11

ACCOUNTING STANDARD – 9
REVENUE RECOGNITION

Quote:
Be miserable. Or motivate yourself. Whatever has to be done, it's always your choice.

1. WHAT IS REVENUE?

Revenue is Gross inflow of cash, receivables or other consideration arising in the course of the ordinary activities of an enterprise from:

- The Sale of Goods,
- The Rendering of services, and
- The Use by others of enterprise resources yielding Interest, Royalties and Dividends.

Examples on Revenue Nature Transactions

Revenue Nature	Non-Revenue Nature
Example 1 ST Ltd is a real-estate developer and builder. It is into the business of buying and selling properties. In 20X1, ST Ltd purchased a unit of land for ₹ 150 crore. It sold off that land after few months at a price of ₹ 240 crore. In the above case, the sale of land is a transaction that happens in the ordinary course of business (as he is a real estate developer and builder – properties will be an item of inventory in the financial statements) for ST Ltd. Hence, it should recognise a revenue of ₹ 240 crore when the land is sold.	**Example 2** Entity XY sells a machine being used at its factory at a price of ₹ 2 lakh. The carrying value of the machine is ₹ 1.80 lakh. The sale of the machine does not increase the revenue of XY but is an example of a capital receipt since transaction does not take place in the normal course of business. Such gain on sale of ₹ 20,000 (₹ 2 lakhs – ₹ 1.80 lakhs) is recognised as a part of profit & loss statement under Gain/(Loss) on disposal of asset.

Example 3	Example 4
Trip Deal is a website that allows people to book airlines tickets. As a part of the business, it agrees to buys 100 tickets from an airline on a particular date and resells those tickets to customers. However, Trip Deal bears the loss for any unsold tickets. In the above example, the risks and rewards relating to tickets are borne by Trip Deal. Hence, sales made for the tickets will be fully recognized as part of its revenue. Any unsold tickets will be charged as loss by the entity.	DL Ltd, a pharma company, has been conducting research on new medicine for the last 2 years to increase the immunity levels of the people consuming it without any side effects. During the current year, it decides to sell the outcome of the research undertaken so far to another competitor, GH Ltd for ₹ 50 crore. DL has already incurred ₹ 30 crore on the ongoing research. In the above example, the sale of the research findings does not represent an increase in revenue. This is because DL Ltd's business is not to sell these research findings in the ordinary course of business. The amount of ₹ 50 crore will be a part of Other Income in the profit & loss statement.

2. MEASUREMENT OF REVENUE:

Revenue is recognised at the nominal amount of **Consideration Receivable (i.e., Agreed Price).**

(a) Any trade discounts or rebates shall be deducted and revenue is measured net of these items.

(b) With regard to exchanges of goods or services (barter transactions):

- When goods or services are of a **similar nature**, then the exchange is not regarded as a revenue generating transaction and **the revenue cannot be recognized**.
- When goods or services are of a **dissimilar nature**, then the exchange is regarded as a revenue generating transaction and the revenue is recognized in amount of **fair value of goods/services received** (adjusted by the amount of any cash transferred).

3. RECOGNITION OF REVENUE

AS 9 specifies revenue recognition criteria for 3 basic revenue generating scenarios:

- Sale of goods
- Rendering of services
- Interest, Royalties and Dividends

4. REVENUE FROM SALE OF GOODS

Revenue from sale of goods is recognized when all of the following conditions are satisfied:

1) The entity has transferred to the buyer the significant Risks & Rewards of ownership of the goods.
2) The entity retains neither continuing managerial involvement to the degree usually associated with ownership nor effective control over the goods sold
3) The amount of revenue can be measured reliably
4) It is probable that the economic benefits associated with the transaction will flow to the entity
5) The costs incurred or to be incurred in respect of the transaction can be measured reliably.

AS 9 sets the practical guidance on recognition of revenue from various situations when selling goods. The summarized list is as follows:

Transaction	Revenue Recognition
Bill and Hold Sales	When the buyer takes title **(i.e., Ownership)**
Goods Shipped Subject to Conditions	
– installation & inspection	When the buyer accepts delivery and installation & inspection is completed.
– on approval	When the buyer formally accepts the shipment
– with limited right of return	When the goods were delivered and time for return lapsed.
– consignment sales	After the consignee sells goods to the final customer.
– cash on delivery sales (e.g., Amazon/Flipkart)	When delivery is made and cash is received by the seller.
Lay Away Sales (a system of paying a deposit to secure an article for later purchase.	When the delivery is made.
Sale and Repurchase Agreements (AS 19)	Look out for financing arrangement – Not Revenue (Treated as Loan Transaction)
Subscriptions to Publications	In line with the period over which the items are dispatched.

Example 5

XY Ltd sells goods worth ₹ 50 lakh on 20 February 20X1 to AB Ltd. AB Ltd is facing storage capacity constraints at their warehouse. AB Ltd instructs XY Ltd to hold the goods at XY Ltd's warehouse and arrange for delivery on 15 March 20X1. However, all the risks and rewards associated with the sold goods are deemed transferred to AB Ltd.

In the current scenario, delivery of goods sold is delayed at the request of buyer. XY Ltd can recognize revenue for sale of goods to AB Ltd on 20 February 20X1 provided that the goods sold to AB Ltd are held in XY Ltd's warehouse separately and are not clubbed with other inventory.

Example 6

M/s XY sells goods worth ₹ 5 lakh on 30th of March 20X1 to M/s FT under Sale on approval basis. Under the arrangement, FT can return the goods back to XY within next 3 months. XY cannot reasonably determine whether FT will give the acceptance of goods before the expiry of 3 months.

Under these circumstances, XY cannot recognize revenue until the goods are accepted by FT or on completion of 3 months, whichever is earlier.

Example 7

On 1st January 20X1, M/s KJ sells goods at invoice value of ₹ 5 lakhs to M/s TH. At the time of sale, M/s KJ has agreed to repurchase these goods back from M/s TH on 31st March at a price of ₹ 6 Lac. You are required to do the accounting for above transactions in the books of M/s KJ.

Solution

This is a **Sale and Repurchase agreement**. In these kinds of transactions, Revenue is not recognized since ultimate control over goods is not transferred. It is treated as a Finance Arrangement.

1st Jan 20X1:

Bank A/c To Loan from M/s TH A/c (Being borrowing made under the Sale & Repurchase arrangement)	Dr.	₹ 5 lakhs	₹ 5 lakhs

31st March 20X1

Interest expense A/c To Loan from M/s TH A/c (Being interest cost recognised on the borrowing)	Dr.	₹ 1 lakhs	₹ 1 lakhs

31st March 20X1:

Loan from M/s TH A/c To Bank A/c (Being repayment of loan taken from TH)	Dr.	₹ 6 lakhs	₹ 6 lakhs

5. REVENUE FROM RENDERING OF SERVICES

Here, can the outcome of the transaction be estimated reliably?

- **If yes,** then the revenue can be recognized by the reference to the stage of completion of the transaction at the end of the reporting period.
- **If not,** then the revenue can be recognized only to the extent of the expenses recognized that are recoverable.

When can the outcome of the transaction be estimated reliably? It is when all the following conditions are satisfied:

- The amount of revenue can be **measured reliably**
- It is probable that the **economic benefits** associated with the transaction will flow to the entity (Certainty of Collection)
- The **stage of completion** of the transaction at the end of the reporting period can be measured reliably and
- The **costs** incurred for the transaction and the costs to complete the transaction can be measured reliably.

STANDARD ALSO PERMITS RECOGNITION AS PER COMPLETED SERVICE CONTRACT METHOD.

AS 9 sets the practical guidance on recognition of revenue from various situations **when rendering services:**

Transaction	Revenue Recognition
Installation Fees	With reference to the stage of completion.
Servicing Fees	If subsequent services are included, then defer the revenue for the subsequent services.
Advertising Commissions	
- Media Commissions	When the related advertisement appears before the public.
- Production Commissions	With reference to the stage of completion.
Insurance Agency Commissions	
- Agent Renders Further Services	Defer over the period during which the policy is in force.
- Agent Does Not Render Further Services	At the date of policy commencement or renewal.
Financial Services/Banking Services	
- Earned As Services Are Provided	When related service is provided.

– Earned On Execution of Significant Act	When related significant act has been completed.
Admission Fees	When the event takes place or allocate proportionally to individual events.
Tuition Fees	Over the period of instruction.
Entrance and Membership Fees	
– No additional services provided	Immediately when membership starts.
– Additional services provided	Defer over the membership period on some reasonable basis.
Franchise Fees	On the basis reflecting the purpose for which the fees are charged.
Fees from Development of Customized Software	With reference to the stage of completion, including the post-delivery service support stage.

6. REVENUE FROM INTEREST, ROYALTIES AND DIVIDENDS

Revenue arising from the use by others of entity assets yielding interest, royalties and dividends shall be recognized when:

- It is probable that the economic benefits associated with the transaction will flow to the entity&
- The amount of the revenue can be measured reliably.

Revenue shall be recognized on the following bases:

1. **INTEREST:** The recognition of revenue from interest on TIME PROPORTION BASIS.
2. **ROYALTIES:** shall be recognized on an ACCRUAL BASIS in accordance with the substance of the relevant agreement.
3. **DIVIDENDS:** shall be recognized when the SHAREHOLDER'S RIGHT TO RECEIVE payment is established (i.e. When Dividend is declared by Paying Co.)

7. POSTPONEMENT OF REVENUE RECOGNITION

Revenue recognition shall be postponed when:

- The Consideration is not determinable or
- The amount of consideration is not certain to be collected
- When uncertainties gets over, Revenue should be recognized.
- If uncertainty about the ultimate collectability of revenue arise after the initial recognition, then enterprises should not reverse the revenue already recognized, it should create a proper Provision.

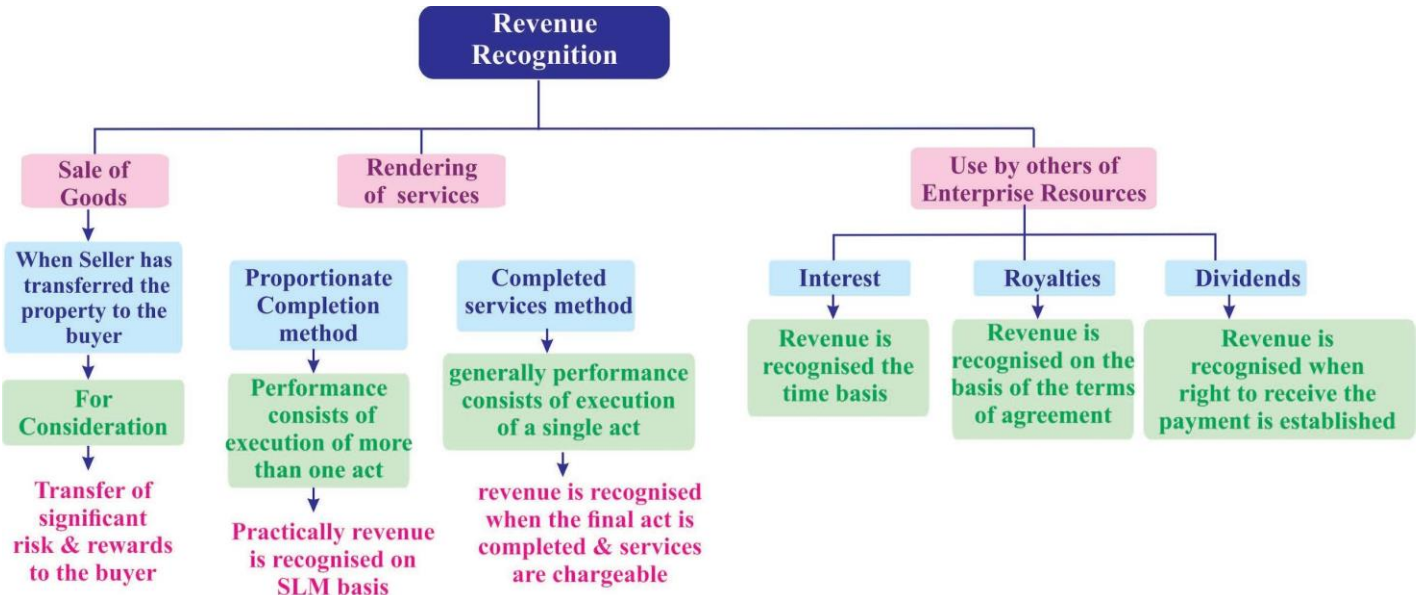
Case 1 – At the date of Transaction, there is no probability of collection – Do not recognise the revenue.

Case 2 – Initially Revenue was recognised because conditions of recognition satisfied. After some time, probability of collection reduced, Do Not Reverse Revenue, Create Provision for bad debts.

8. PRESENTATION OF TURNOVER:

Turnover should be presented in the following manner:

Turnover	Gross
Less:	GST
Turnover	**(Net)**



9. IMPORTANT KEY POINTS

1. **What is Gross Inflow?**

Gross Inflow is depends on following:

a) If there is transaction of Principal & Agent
- Gross Inflow for Principal would be amount charged from customers without deducting Commission
- Gross inflow for agent will be Commission receivable from principal

b) If there is transaction of Principal to Principal
- Gross Inflow for P1 will be amount charged from P2
- Gross Inflow for P2 will be charged from Customer

2. Interest income can be treated as "Revenue" if an Entity's Main Operating business is Financing Activity. E.g. Banks, NBFC
3. Revenue can be Royalty received by transferring "technical know how or patents" to other party if such transfer is a part of Ordinary Business.
4. Dividend can be Revenue if entity is an Investment entity (Mutual Fund Companies)

5. **Exchange Transaction**

(a) **Exchange of Similar G/S to Facilitate sales with similar business entities** - It's not a revenue transaction

(b) **Exchange of dissimilar G/S** - Revenue will be equal to Fair value of Consideration receivable.

e.g.: A ltd. provided consultancy service for Infrastructure & Interior to a builder & in Consideration A Ltd. will get 1 5BHk flat with garden facing. Revenue for A Ltd. would be Fv/MP of 5 BHK Flat.

6. **Rendering of Service -** Is the outcome of Service Probable?

(a) **YES -** Revenue is recognised on the basis of %(PCM) or Completed Service Method

(b) **NO** - Revenue = Cost incurred till date of which recovery is probable

7. **How to identify that outcome is probable?**

All 4 Conditions must be satisfied:

(a) Revenue amount is measured reliably. Price is mutually agreed between seller/buyer.

(b) Certainty of collection of revenue

(c) Percentage of Completion can be measured reliably.

(d) Cost should be measured reliably.

10. MCQ's from ICAI Material

1. Which of the conditions mentioned below must be met to recognize revenue from the sale of goods?

(i) the entity selling does not retain any continuing influence or control over 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.

(a) (i), (ii) and (v)
(b) (ii), (iii) and (iv)
(c) (i), (iii) and (v)
(d) (i), (iv) and (v)

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?

(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 in the pricing can only be approved by the manufacturer.
(d) Manufacture is responsible for the holding the goods and any changes in the pricing can only be approved by the dealer

3. Which of the following transactions qualify as revenue for M/s AB Enterprises?

(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

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:

(a) ₹ 5,25,000
(b) ₹ 5,10,000
(c) ₹ 5,00,000
(d) ₹ 5,15,000

5. Flix Net 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

(a) ₹ 100

(b) ₹ 1,200

(c) Nil

(d) ₹ 1,100

ANSWERS	1	2	3	4	5
	c	c	c	c	b

CA NOTES COMMUNITY NETWORK

Click on Icon	QR CODE	LINK
Join what's App group		CLICK HERE
Join Telegram Channel		CLICK HERE
Subscribe On Youtube		CLICK HERE
Follow us On Instagram		CLICK HERE

BE A PART OF CNC FAMILY

CNC – CA NOTES COMMUNITY

Mail at (for complaints/feedback) – canotescommunity@gmai.com

ABOUT THE AUTHORS

CA Jai Chawla

CA JAII CHAWLA is the core faculty of **V'Smart Academy, Pune and D7 Fortune Classes, Bhopal**

He has a leading experience of more than 12 years of CA INTER ADVANCE ACCOUNTS & CA FINAL FINANCIAL REPORTING and has guided more than 1,20,000 students across India. His Quality of teaching and friendly behavior along with the tendency to guide and help each student in the best possible ways, makes him so loving among the students

His vision is to share his knowledge and skills to benef t the students and inculcate the tendency of learning and enchanting knowledge which may lead them towards the success.

His Chart Revisions & Question Bank discussion videos on Youtube are very popular across India.

Dammini Jai Chawla

DAMMINI JAI CHAWLA is the co-founder and proud owner of D7 FORTUNE CLASSES, BHOPAL. She is the First Class MBA degree holder & a student of CA Final and CS Professional.

Her management and communication skills made D7 FORTUNE, a known brand in a short span of 2 years. She is also engaged in counseling & managment and doubt clearing sessions of INTER in D7 FORTUNE CLASSES. She has devoted and dedicated her crucial time in supporting her husband to all the possible extent. She believes in CA JAI CHAWLA'S dream and vision as her own.

She is the **Co-author of various Books of CA FINAL FINANCIAL REPORTING and CA INTER ADVANCE ACCOUNTS.**

PREFACE

DEAR STUDENTS,

Hi Friends
Cheers to the moment!
When I am delighted to introduce this before you, 'TRUMP'. Yes it will be a trump card for students .haw?

This is the book which will provide **an in-depth understanding** of “Accounting Standards” along with multiple Concept Builder Examples.

This book is one stop destination for covering all Accounting Standards thoroughly in a very short span of time.

This compilation would not be a reality without the immense efforts of my wife DAMMINI JAI CHAWLA, and this is her idea to provide to the dearest students, having the primary objective to create a friendly relation of student with the books and it is very important to divide and compress the book into concised form in a Simple and Student Freindly language.

This book covers all the Accounting Standards of CA INTER with all the concepts **including Question Solving Techniques**. This handy book can be carried anywhere and is sufficient to understand logics with conceptual clarity.

This will ease your way to score better marks than your expectations.
And finally, a special thank to my Parents Shri Girish Chawla (Father), Smt. Kanchan Chawla (Mother).

Also, a very heartfelt thanks to my Previous batch students **specially students of Nov. 23 Batch (aka Safed Chuhe Batch) and Jan’25 Batch (aka Extra-ordinary batch), to whom I have introduced multiple examples and conceptual summaries of AS** so that to incorporate in this book for the better understanding and practice and I am glad that they were more enthusiastic and energetic to help me with this mission.
It’s the students who make us and keep us going.

It well be immense pleasure for me, to receive your views and feedback on this book on the number mentioned below.

At Last I would say one thing to all of you - तुम सब लगे रहो मैं तुम्हारा अंत तक साथ दूंगा !

YOUR DOST MENTOR & GUIDE
CA. JAI CHAWLA
7887 7887 05

How To As
DOUBTS

HOW TO ASK STUDY RELATED DOUBTS ?

1. You can WhatsApp yourQuery/Doubt along with the image of Question and Solution if any. (7887 7887 05)

2. Normally Me & My Team will try to reply within a day or two but pls have some patience for 3-4 days, after that u can call us on the same number to remind if u haven't got any reply.

3. Doubts will be entertained only on WhatsApp orDedicated Telegram Groups of the batch if any.

Let's Stay Connecte

Subscribe our Youtube Channels for Video

Jai Chawla Sir

V'Smart Academy

Connect with Me for Free Resources

CA. Jai Chawla
Telegram Channel

CA. Jai Chawla
Whatsapp Channel

Lets Follow Each other on Insta

INDEX

VOLUME - 2

INDEX

VOLUME - 2

12

ACCOUNTING STANDARD – 4 CONTINGENCIES & EVENTS AFTER THE BALANCE SHEET DATE

QUOTE:

Keep Going, Difficult Roads Can Lead to Beautiful Destination

1. NON-APPLICABILITY

1. Liabilities of Life Assurance and general Insurance companies.
2. Obligations under Retirement Benefit Plans (AS 15).
3. Commitments arising from Long Term Lease Co

2. MEANING OF EVENTS AFTER THE BALANCE SHEET DATE

Events (favorable or unfavorable) after the Balance Sheet date are those events that occur between the end of the reporting period and the date when the financial statements are approved by competent authority (Such as Board of Directors).

Example:

On 18th May,20X2, the management of an entity approves financial statements for issue to its supervisory board. The supervisory board is made up solely of non-executives and may include representatives of employees and other outside interests. The supervisory board approves the financial statements on 26th May,20X2. The financial statements are made available to shareholders and others on 1st June,20X2. The shareholders approve the financial statements at their annual meeting on 15th July,20X2 and the financial statements are then filed with a regulatory body on 17th July,20X2.

The financial statements are **approved for issue on 18th May,20X2** (date of management approval for issue to the supervisory board).

3. TYPES OF EVENTS AND THEIR TREATEMENT

ADJUSTING EVENTS	NON-ADJUSTING EVENTS
Events which provide evidence of conditions that exist on balance sheet date.	***Events that are Indicative of conditions that arose after the reporting period.*** The events not related to circumstances/conditions existed on Balance sheet date; in other words, entirely new events after the BS date.
Examples: **1.** Debtor declared insolvent after long outstanding receivable. **2.** Settlement of litigation after balance sheet date (litigation started before balance sheet date) **3.** Detection of fraud or error after balance sheet date. **4.** Asset sold before balance sheet, consideration received after balance sheet date.	Examples: **1.** Decline in the fair value of investments after the Balance Sheet. **2.** Destruction of Assets of the entity by floods occurring after the reporting period. **3.** Negotiation to purchase Property initiated before balance sheet date but actual transaction completed after balance sheet date.
ACCOUNTING TREATMENT: Adjust the Assets/Liabilities of Financial Statement is ended.	ACCOUNTING TREATMENT: No need to adjust the Assets/liabilities of financial statements. Only disclosure is required in case of material event.

Example of Inventory

Entity A values its inventories at cost or NRV, whichever is less. Entity A has 10 pieces of item A in its stock at the year end. Each item costs Rs. 500. All these items are sold subsequently but before the date of approval of financial statements for the reporting period at Rs. 450 per piece. The sale of inventories after the reporting period normally provides evidence about their net realisable value at the end of the reporting period.

4. SPECIAL ITEMS:

1. Equity Dividend Declared	2. Going Concern
Dividend is declared after the balance sheet i.e. generally in AGM Hence there is no obligation regarding the balance sheet date. Hence it is always treated as a Non-adjusting event.	If after the Balance Sheet date, the entity's going concern assumption is no longer appropriate due to happening of an event, then it should adjust Assets and Liabilities of financial statement. (i.e. it is treated as an adjusting event) Entity should not prepare its financial statements as per Going Concern Basis.

5. (MCQ's from ICAI Material)

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.
   (a) An Adjusting event.
   (b) Non-adjusting event.
   (c) Contingency.
   (d) Provision

2. As per Accounting Standards, events occurring after the balance sheet date are
   (a) Only favourable events that occur between the balance sheet date and the date when the financial statements are approved by the Board of directors.
   (b) Only unfavourable 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 favourable and unfavourable, that occur between the balance sheet date and the date on which the financial statements are approved by the Board of directors.
   (d) Those significant events, both favourable and unfavourable, that occur between the balance sheet date and the date on which the financial statements are not approved by the Board of directors.

3. AS 4 does not apply to
   (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) Both (a) & (b).

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
   (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.

ANSWERS	1	2	3	4
	a	c	d	c

13

ACCOUNTING STANDARD – 7
CONSTRUCTION CONSTRACTS

Quote:

"Limitations live only in our Minds, But if we use our imaginations,
Our Possibilities become Limitless"

1. INTRODUCTION

AS 7 defines Construction Contract as a contract specifically negotiated for the construction of:

- an Asset; or
- a combination of assets that are closely interrelated or interdependent in terms of their design, technology, function, ultimate purpose or use.

The construction contracts in AS 7 include contracts for:

(a)The rendering of services which are directly related to the construction of the asset; &

Example: Contract for the services of project managers, architects& Labour.

(b) The destruction or restoration of assets, and the restoration of the environment following the demolition of assets.

Example: Contract for Demolition of Factory Building to save Environment.

2. TYPES OF CONSTRUCTION CONTRACT

Construction Contracts are of two types:

a. **Fixed price contracts** - In this case of contract, contractor agrees for fixed price of the contract or fixed rate/unit. However, in some cases the contract price is subject to escalation.
b. **Cost-plus contract** - In these contracts, contractor is reimbursed the Cost plus fixed percentageof profit.
c. **Hybrid** - Mixed of above two.

EXAMPLE 1 (Cost Plus Contract):

ABC Constructions has a contract to build an office building. The terms and conditions are as under:

1. ABC's profit is agreed at:
   - 25% on expected contract's cost; For this purpose, the expected cost cannot exceed ₹ 22 crores.
2. The agreed price will be revised depending upon the actual cost incurred.
   - The cost for fixation will be taken actual cost or ₹ 22 crores whichever is less.

Price fixation based on expected cost:

Assume that the costs expected to be incurred by ABC are ₹ 16 crore. Thus, ABC can charge a profit of ₹ 4 crores (25% on actual cost).

The contract price will be ₹ 20 crores. (₹ 16 crores plus ₹ 4 crores)

Price fixation based on actual cost incurred – Scenario 1:

However, if cost incurred by ABC is ₹ 15 crore, in that case, it would be able to charge a profit of:

= 25% on ₹ 15 crore = 15 x 25% = ₹ 3.75 crore

Thus, Total Value of the contract will stand revised as follows:

= Actual Costs + Profit (25% of costs) = ₹ 15 crore + ₹ 3.75 crore = ₹ 18.75 crores.

Price fixation based on actual cost incurred – Scenario 2:

For any unavoidable reasons, if total cost incurred by ABC is ₹ 25 crore, it can only charge a profit on the expected costs of ₹ 22 crore as under:

Thus, Total Value of the contract will stand revised as follows:

= Expected Costs + Profit (25% of costs) = ₹ 22 crore + ₹ 5.50 crore = ₹ 27.50 crores.

Analysis of the above scenario:

Cost actually incurred by ABC = ₹ 25 crores.

Actual profit earned by ABC = Total Value of the contract – Actual costs incurred

= ₹ 27.50 Crores – ₹ 25 Crores = ₹ 2.50 Crores.

3. CALCULATING THE PROFIT OR LOSS OF A CONSTRUCTION CONTRACT

Profit or Loss on Construction contract is = Contract Revenue - Contract Cost

A. CONTRACT REVENUE:

Contract revenue can be recognised when there is no significant uncertainty exits regarding the amount of collection. It is calculated as below:

Price Agreed as per contract	XXX
(+) Revenue arising due to escalation clause	XXX
(+/-) Variations due to change in scope of Work	XXX
(+) Claims recoverable from customers in the form of reimbursements	XXX
(+) Incentives recoverable from customers on achieving the Targets	XXX
(-) Penalties Payable to customers for any delay	XXX
Total Contract Revenue	XXXX

Note:

Variations, Claims, Incentives and Penalties are considered only when:

(i) When there is certainty of collection/payment; and

(ii) they can be measured reliably

B. CONTRACT COSTS

Contract costs consist of the following:

Specific Costs of Completing the Contract:	
Material Cost	XXX
Labour Cost	XXX
Depreciation of PPE used in Contract	XXX
Cost of Hiring the PPE	XXX
Cost of design & technical assistance	XXX
(-) Incidental income (sale of scrap material)	XXX
Cost Attributable to Contract:	
Insurance Exp	XXX
Overhead cost allocated to the Contract	XXX
Pre contract cost (cost incurred to secure the contract)	XXX
Total Contract Cost	XXXX
Contract Cost incurred during the year Also means = Work Certified + Work Uncertified	

These expenses are not a part of Contract Cost: General administration cost, Selling cost, Research and development & Abnormal Loss.

4. PERCENTAGE OF COMPLETION METHOD (PCM)

As per AS 7, the contract revenue will be recognised with reference to **the Percentage of Completion** (PCM) at the reporting date.

Determination of Percentage of Completion:

Cost Approach	Technical Survey Approach
% of Completion = $\frac{\text{Cost Incurred Till date}}{\text{Total Est. Cost of Project}} \times 100$ Cost Incurred Till date also means = Work Certified + Work Uncertified	% of Completion is calculated in reference to the survey conducted by Certified Engineer for each and every part of the project. Refer Example below

Example 2: A construction contract of a two floor building for Rs. 15 lakhs (with a 50% margin)

Divisions of contract	Technical Completion	Cost to complete
Foundation	35%	5
1st Floor	10%	1
2nd Floor	15%	1
Tiling, painting, fitting etc.,	40%	3
	100%	**10**

Foundation work was completed.

Conclusion:

a) Under the cost to cost method, revenue of Rs.7.5 lakhs (15 Lakhs X 5/10 Lakhs) would be recognised & cost of Rs.5 lakhs would be recognised and profit of Rs. 2.5 lakhs would be recognised.

b) Under the Technical survey method, revenue of Rs. 5.25 lakhs (35% of Rs. 15 lakhs) would be recognised, cost of Rs.3.5 lakhs (35% of Rs. 10 lacs) would be recognised and a profit of Rs. 1.75 lacs would be recognised.

5. IMPORTANT PROVISIONS FOR REVENUE RECOGNITION

Outcome of Contract	Revenue Recognition is based on Outcome of Contract as under: 1) When the outcome of the contract is estimated reliably, Revenue should be recognised as per % of Completion Method 2) When the outcome of the contract cannot be estimated reliably, Revenue should be recognised only to the extent of contract costs incurred_of which recovery is probable. (i.e. Revenue = Cost incurred i.e. No Profit/Loss)
Total Contract Cost will exceed Total Contract Revenue	When it is probable that total contract may exceed total contract revenue then Expected loss should be immediately provided for.
Subsequent uncertainty in collection	Once revenue is recognised and then uncertainty of collection arise, in such case it is better to make provision for doubtful debts instead of reversing the revenue.

Example 3:

X Ltd. commenced a construction contract on 01/04/X1. The contract price agreed was reimbursable cost plus 10%. The company incurred Rs.1,00,000 in 20X1-X2, of which cost of Rs.90,000 is reimbursable. The further non-reimbursable costs to be incurred to complete the contract are estimated at Rs.5,000. The other costs to complete the contract cannot xbe estimated reliably.

SOLUTION:

Profit & Loss Account

	Rs.000		Rs.000
To Construction Costs	100	By Contract Price (90+9)	99
To Provision for loss	5	By Net loss	6
	105		**105**

6. PRESENTATION IN FINANCIAL STATEMENTS

An enterprise should present:

(i) the Gross Amount due from customers for contract work as an asset; and

(ii) the Gross Amount due to customers for contract work as a liability.

Particulars	Amount
Cost Incurred + Recognised Profits - Recognised Losses/Recoveries Not Possible - Progress Billings	

Total Amount If Amt. is positive then Due from Customer If Amt. is Negative then Due to Customer	XXX

Note:
PROGRESS BILLING MEANS = PAYMENT RECEIVED + RETENTION

7. SUMMARY of ABOVE

Based on above Discussion we can summarize following Key Points-

1. **Contract Revenue** shall be recognized **based on PCM** until and unless the outcome of contract cannot be estimated probably.
2. If Outcome cannot be estimated probably **then do not apply PCM,** Revenue shall be recognize only to the extent of Actual Cost Incurred till date of which recovery is Probable.
3. **Contract Cost** shall be recognized based on Actual Cost incurred during the Period. PCM shall not be applied on Contract Cost.

EXAMPLE 4:

Contractual Team = 3 Years

Year	1	2	3
Contract Cost incurred during the year	7,20,000	11,70,000	15,60,000
Further Estimated cost to be incurred	25,00,000	14,00,000	-

Calculate % of Completion for Every Year.

SOLUTION

1st Year = 7,20,000 / (7,20,000 + 25,00,000) x 100 = 22.36%

2nd Year = 18,90,000 / (18,90,000 + 14,00,000) x 100 = 57.45%

3rd Year = 100%

EXAMPLE 5:

	(₹ IN Cr.)		
	1	2	3
Cost incurred till date	1,500	3,750	6,200
Further estimated cost to be incurred	4,500	2,400	0

Total fixed price agreed with customer = 8,000

SOLUTION

	1	2	3	
% of completion	25%	61%	100%	
Cumulative Revenue	2,000	4,880	8,000	
Current Year Revenue	2,000	2,880	3,120	
Current Year Cost	1,500	2,250	2,450	

Profit	**500**	**630**	**670**	**1,800**

% = Cost incurred till date/Total Estimated Cost

EXAMPLE 6: (Provision for Expected Loss)

Contractual Term = 3 Years

Contract Revenue = 3000 Cr.

	1	2	3
Contract Cost incurred till date	800	1900	3200
Further Estimated cost to be incurred	1750	1300	-

Calculate Contract Profit/Loss every year.

SOLUTION:

	1	2	3
	800/2,550 x 100 = 31.37%	1,900/2,550 x 100 = 59.38%	100%
Cumulative Revenue	941	1,781	3,000
Current Year Revenue	941	840	1,219
Current Year Cost	800	1,100	1,219**
Current Year Profit/Loss	141	(260)	0
Loss till date Recognised	-	260-141 = 119	
Loss to be Recognised	-	200-119 = 81*	

* As per AS 7 (Contract Cost) when total Construction Cost is expected to be in excess of Contract Revenue then Loss should be provided for immediately.

**Cost to be recognised = 3,200 – 1,900	1,300
(-) Loss already Recognised	(81)
Cost to be Recognised	**1,219**

EXAMPLE 7:

Consider the following % of Completion in a 3 Years Construction Project:

Year 1 – 25%

Year 2 – 61%

Year 3 – 100%

Total agreed price of contract = 2,50,00,000

Year	1	2	3
Addition / deduction in Price	(4,50,000)	7,00,000	20,00,000
	penalty	Escalation clause	Modification (Additional Assets)

How much Revenue shall be recognised every year?

SOLUTION:

Year 1

Agreed Price	2,50,00,000
(-) Penalty	4,50,000

Revised Price	2,45,50,000
% of Completion	25%
Revenue	61,37,500/-

Year 2

Earlier Agreed Price	2,45,50,000
(+) Escalation	7,00,000
Revised Price	2,52,50,000
% of Completion	61%
Cumulative Revenue till 2nd Year	1,54,02,500
(-) Revenue Recognition in 1st Year	(61,37,500)
Current Year Revenue	92,65,000

Year 3

Earlier Agreed Price	2,52,50,000
(+) Modification	20,00,000
Cumulative Final Price	2,72,50,000
(-) Revenue already Recognised till date	1,54,02,500
Current Year Revenue	1,18,47,500

EXAMPLE 8:

Agreed Price = 5,000 lakhs

Term = 3 Years

Year	1	2	3
Contract Cost incurred till date	1,750	4,500	5,200
Estimated Total Cost	4,650	5,200	5,200
PCM (%)	37.63%	86.54%	100%

SOLUTION:

Year 1

Revenue	1,881.50
(-) Cost	1,750
Profit	131.50

Year 2

Cumulative Revenue	4,327
(-) Last Year Revenue	1,881.50
Current Year Revenue	2,445.50
(-) Cost of Current Year	2,750
Current Year Loss	304.50

Position of Profit/Loss till 2nd Year = 131.5 – 304.5 = 173

Loss Already Recognised till Date = 173

*When entity estimates that overall contract Cost will exceed overall Contract Revenue, then Loss to the Contract will be Recognised Immediately.

Therefore,

Revenue	5,000
Estimated Cost	(5,200)
Estimated loss of entire Contract	200
Loss already Recognised	(173)
Extra Loss to be recognised immediately	**27**

How to Measure Revenue when there is Incentive but such incentives are Variable?

Example 9:

Agreed Price = 50 lakhs

Total Term = 3 Years

Inventive is: -

(a) Either 5%, if work completed within 3 Years

(or)

(b) 10%, if work completed within 30 months

There is a 80% Probability that work will be Completed within 30 months & 20% Probability of beyor 30 months.

Calculate total revenue expected from contact.

SOLUTION: -

Total Revenue = Agreed Revenue + Incentives (Estimated)

Estimated Incentive: -

10% x 80% = 8%

5% x 20% = 1%

Weighted Average Incentive = 9%

Total Revenue = 50,00,000 + 9% = 54,50,000

8. IDENTIFYING CONSTRUCTION CONTRACT

Single Contract of Multiple Assets	Treat Separate Contract for each Asset if all these conditions are satisfied: **a)** Separate proposals are submitted for each asset; **b)** Each asset is subject to separate negotiation i.e. both contractor and customer have the ability to accept some part and reject some part of the contract; **c)** Cost and Revenue of Each Asset can be identified separately.
Contract Combinations: Two or More contracts with Same party entered into or near the same time be considered a "Single Contract" if **any one** of these conditions are met.	**Conditions:** **a)** The contracts are negotiated as a package. OR **b)** All or major assets are contracted for a common objective. It means assets are dependent or inter-related with each other. Here in this case, Single PCM shall be calculated for all the Assets Contract combined.
Additions to the Contract	When there is any addition to the existing contract then such additional assets are treated as separate contract if any one condition is satisfied: **a)** The additional Asset is clearly distinct from the Existing Asset under the contract in respect of design, location, function or technology. **b)** The Price of additional asset is negotiated separately without considering the original contract (i.e. Contractor is Charging Standalone price for that Additional Asset)

Example 10:
B Limited has taken a construction contract from the authority to develop a township.
The contract involves several other contracts such as residential complexes, roads, power stations, reservoirs and commercial complex. Separate tenders were floated and separate proposals have been submitted for the same. Negotiations have been separate. However, all the contracts have been awarded to B Limited. This will be a case of segmenting the contracts as there are separate proposals, separate negotiations, the award of one contract has no relationship with the other and costs and revenues of each contract are separately identifiable.

9. (MCQ's from ICAI Material)

The below information relates to Questions 1 – 3:

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

2. Total expense to be recognised in Year 1 is
   (a) ₹ 30 lakh
   (b) ₹ 120 lakh
   (c) ₹ 38 lakh
   (d) ₹ 36 lakh

3. Revenue to be recognised for year 2 is
   (a) ₹ 84 lakh
   (b) ₹ 42 lakh
   (c) ₹ 56 lakh
   (d) ₹ 28 lakh

Below information relates to Questions 4 – 6

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

4. Revenue to be recognised by M/s AV is
   (a) ₹ 320 lakh
   (b) ₹ 370 lakh
   (c) ₹ 360 lakh
   (d) ₹ 400 lakh

5. Total expense to be recognised by M/s AV is
   (a) ₹ 360 lakh
   (b) ₹ 400 lakh
   (c) ₹ 320 lakh
   (d) ₹ 360 lakh

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 ₹ 100 lakh. 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:
   (a) ₹ 40 lakh
   (b) ₹ 10 lakh
   (c) ₹ 90 lakh
   (d) ₹ 50 lakh

ANSWERS	1	2	3	4	5	6
	a	d	c	a	d	b

CA NOTES COMMUNITY NETWORK

Click on Icon	QR CODE	LINK
Join what's App group		CLICK HERE
Join Telegram Channel		CLICK HERE
Subscribe On Youtube		CLICK HERE
Follow us On Instagram		CLICK HERE

BE A PART OF CNC FAMILY

CNC – CA NOTES COMMUNITY

Mail at (for complaints/feedback) – canotescommunity@gmai.com

14 ACCOUNTING STANDARD – 11 "EFFECTS OF CHANGES IN FOREIGN EXCHANGE RATES"

"The Pessimist Sees Difficulty in Every Opportunity. The Optimist Sees Opportunity in Every Difficulty."

THIS AS DEALS WITH: -

- Treatment of Foreign Currency Transactions
- Translation of Financial Statements of Foreign Operations (Branch/Subsidiary)
- Forward Exchange Contracts. (Hedge and Speculation)

1. FOREIGN CURRENCY TRANSACTIONS

1.1 DEFINITIONS

Currencies – For the purpose of this AS, there are two types of Currencies

(a) **Reporting Currency** – Any Currency in which Financial Statements are reported.

(b) **Foreign Currency** – Any Currency other than Reporting currency.

A Foreign Currency Transaction is a transaction which is denominated in or requires settlement in a foreign currency for example – sale or purchase of goods in Foreign Currency, Borrowings or Lending or Investing in Foreign Currencies etc.

Monetary items are money held and assets and liabilities to be received or paid in fixed or determinable amounts of money. For example, cash, receivables and payables.

Non-monetary items are assets and liabilities other than monetary items. For example, fixed assets, inventories and investments in equity shares.

Foreign Currency Monetary Items are Monetary Items which are to be settled in Foreign Currency (i.e., Receivable or Payable in Foreign Currency)

1.2 RECOGNITION AND MEASUREMENT

Two important questions?

Q1. What is Initial Recognition?

Initial Recognition means first time recording in the books of accounts of Foreign Currency Transaction.

Q2. What is Subsequent measurement?

Subsequent Measurement means measurement at Balance Sheet date of Foreign Currency Monetary Items (FCMI) arising out of Foreign Currency Transactions.

Initial Recognition: All foreign exchange transactions are converted into reporting currency using Spot exchange rate or approximate rates (i.e., the exchange rate prevailing on the date of Transaction).

Examples of Foreign Currency Transactions:

- Buying or selling of Goods and Services in Foreign Currency;
- Borrowing or Lending Money in Foreign Currency;
- Acquisition or Disposal of Assets in Foreign Currency;
- Incurring or Settling any Liability in Foreign Currency

Subsequent Measurement (at BS date):

- This recognition is applied on Foreign currency Monetary Items (FCMI) and Non-Monetary Items carried at fair value or measured at other than cost.
- Subsequent measurement is applied for preparing financial statements.
- Any exchange difference arising on subsequent measurement at Balance Sheet date shall be transferred to Profit & Loss a/c.

S.NO.	Financial Statement Items	Exchange Rates
1	Monetary Items i.e. FCMI (e.g., Foreign Receivables or Payables)	Exchange Rate **at the Reporting Date** (i.e., Closing Exchange Rate)
2	Non-Monetary items at historical cost (e.g., PPE)	Exchange Rate at **the date of transaction** (i.e., Spot Rate)
3	Revalued Non-monetary items or Items Measured at Fair Value (E.g., Inventory, Investments in Equity Shares) **Refer Example No 3**	Exchange Rate at the **date of Fair valuation** or **Revaluation** **Example:** the cost or carrying amount, as appropriate, is translated at the exchange rate at the date when that amount was determined; and the net realisable value or recoverable amount, as appropriate, is translated at the exchange rate at the date when that value was determined.

Note: Foreign Currency Monetary Items (FCMI): FCMI are those Assets/Liabilities whose amount is Fixed under contract and they are to be settled in foreign currency. For example, Receivable, Payables, Cash Balances.

Example 1:

Mr. A Purchased Goods of $30,000 on 1/Feb for which payment to be made in next year 30/4

Issue 1: How to record on 1/Feb because it is in $

Issue 2: What to do on Balance Sheet Date i.e., 31/3 because $ Changes

Issue 3: on 30/4 Settlement is in $ the how to Measure?

Solution:

Issue 1:

As per AS 11, all Foreign Currency transaction must be recorded at the rate prevailing on transaction Date (i.e. SPOT Rate)

Suppose 1st Feb $1 = 76/-

Transaction Vale = $30,000 x 76 = 22,80,000/-

1st Feb:

Purchase A/c	Dr.	22,80,000	
To Foreign Creditor A/c			22,80,000

Trading A/c

To Purchases	22,80,000		

Balance Sheet

Foreign Creditors ($30,000)	22,80,000		

Issue 2:

On 31st March $1 = ₹ 77

As per AS 11, All Monetary Assets/Liabilities which are in foreign Currency (FCMI) should be measured at Closing Exchange Rate on Balance Sheet Date.

Revised Foreign Creditors = $30,000 x 77 = 23,10,000

Exchange Difference (Loss) = 23,10,000 – 22,80,000 = 30,000

31/3

Exchange Loss A/c	Dr.	30,000	
To Foreign Creditor A/c			30,000

As per AS 11, Exchange Difference due to measurement of FCMI should be transfer to P&L A/c

31/3

P&L A/c	Dr.	30,000	
To Exchange Loss A/c			30,000

Trading A/c

To Purchases To Exchange Loss	22,80,000 30,000		

Balance Sheet

Foreign Creditors ($30,000)	23,10,000		

Issue 3:

At the time of settlement $ again Change to ₹ 77.80

Amount to be paid in ₹ = $30,000 x 77.80 = 23,34,000/-

30/4

Foreign Creditors A/c	Dr.	23,10,000	
Exchange Loss A/c	Dr.	24,000	
To Bank A/c			23,34,000

As per AS 11, Exchange Difference at settlement shall be transferred to P&L A/c

Example 2:

On 1st Feb, Entity purchased PPE at $25,000 & Paid immediately

$1 = ₹ 76 (on 1st Feb)

$1 = ₹ 77 (on 31/3)

Apply AS 11.

Solution:

As per AS 11, all foreign Currency Transaction must be recorded & measured at the rate prevailing on transaction date. (SPOT Rate)

Transaction Value in ₹ = $25,000 x 76 = 19,00,000/-

PPE A/c Dr. To Bank A/c	19,00,000	19,00,000

Example 3: (Subsequent Measurement of Foreign Currency Non-Monetary Item)

Inventory purchased costing $10,000 in cash as 1/4/23. On 30th June inventory is unsold.

Case 1: NRV is $12,000 on 30th June

Case 2: NRV is $ 9000 on 30th June & it is measured on 10th July

Rate of $1 on 1/4/23 = ₹80, on 30th June $1 = ₹ 82/- and on 10th July $1 = ₹ 82.5/-

Solution:

1) **Initial recognition of Foreign Currency Transaction**

Cost of Acquisition = $10,000 × 80/- = Rs. 8,00,000

01/04/23	Purchase a/c Dr	8,00,000
	To Bank a/c	8,00,000

2) **Subsequent measurement on 30th June (BS Date)**

Case 1:

Cost =$10,000

NRV = $12,000

Since Cost is Lower, It is a non-monetary item measured at cost.

Conclusion:

No need to remeasure at New Ex Rate, it should be Continued at Historical Rate.

Balance Sheet	
Inventory ($10000)	8,00,000

Case 2: Cost =$10,000; NVR = $ 9000

Therefore, Inventory is non-monetary item, measured at other than cost.

As per AS 11, this is to be measured at Exchange Rate on the date of Valuation of NRV i.e 10th July = $1 = Rs. 82.50/-

Total Inventory value = $9000 x 82.5/- = Rs. 7,42,500/-

Trending a/c			
Debit		Credit	
Purchase	8,00,000	Closing stock	742500

PARA 46 OF AS 11 ON TREATMENT OF LONG TERM FOREIGN CURRENCY MONETARY ITEMS UNDER SUBSEQUENT MEASUREMENT

Para 46 has been introduced in AS 11 with retrospective effect from 7th December 2006 amended on 31st March, 2009.

(a) Corporate/Non-Corporate entities can opt for the application of this Para & option is irrevocable.

(b) FCMI of Long Term in nature (whose realization/payment is beyond 12 months from the date of original transaction) will be converted using closing rate in subsequent recognition.

Exchange difference arising from above point will be recognized as follows:

- Transfer Exchange difference to value of Depreciable Fixed Assets (PPE) if long term monetary item was taken to finance such Depreciable F.A. (i.e., to be capitalized if debit difference and subtracted if credit difference) (Refer Example No. 4)
- Transfer Exchange difference to Foreign Currency Monetary Items Translation Diff a/c (FC MIT Diff a/c) if Long Term Monetary Item has no relation with Depreciable Fixed Assets. (Refer Example No. 5)
- FC MIT Diff a/c will be amortised over the balance period of such long-term assets or liability, by recognition as income or expense in each of such periods (written off in periods equally till the life of LTFCMI.)

The balance in FC MIT Diff a/c (debit or credit) should be shown on the "Equity and Liabilities" side of the balance sheet under the head "Reserves and Surplus" as a separate line item. (as decided by the council of ICAI)

Example 4:

Vsmart Ltd. took a Foreign Currency Loan of $1,00,000 to purchase machine of the same amount. On 1st April, 2022 Loan is of 5Years. To be repaid in lumpsum after 5 Years.

Depreciation Rate is 10%

Exchange rates are as follows:

On 1/4/22 - $1 = ₹ 78

On 31/3/23 - $1 = ₹ 82

On 31/3/24 - $1 = ₹ 80.5

Show A/c as per AS 11 in following cases:

(a) Without PARA 46

(b) With PARA 46

Solution:

1) Initial Recognition:

Foreign Currency should recognise at the rate prevailing on transaction Date (i.e. SPOT Rate) i.e. $1 = ₹ 78

Transaction Value = $1,00,000 x 78 = 78,00,000

1/4/22

Machine A/c Dr. To Foreign Currency Loan A/c	78,00,000	 78,00,000

(Note: assuming machine is measured at cost always)

(Note: Foreign Currency Loan is a LTFCMI)

2) Subsequent measurement:

Case 1: without PARA 46

Exchange Difference due to Subsequent measurement shall be transfer to Profit & Loss A/c

1st Year end: 31/3/23

Foreign Currency Loan Should be = $1,00,000 x 82 = 82,00,000

Exchange Difference (Loss) = 4,00,000

31/3/23

Exchange Difference (P&L) A/c Dr. To Foreign Currency Loan A/c	4,00,000	4,00,000
Profit & Loss A/c Dr. To Exchange Difference A/c	4,00,000	 4,00,000

2nd Year end: 31/3/24

Foreign Currency Loan Should be = $1,00,000 x 80.5 = 80,50,000

Exchange Difference (Gain) = 82 – 80.5 = 1,50,000

Foreign Currency Loan A/c Dr. To Exchange Difference (P&L) A/c	1,50,000	 1,50,000
Exchange Difference (Gain) A/c Dr. To Profit & Loss A/c	1,50,000	 1,50,000

Case 2: with PARA 46

Exchange Difference should be adjusted to the cost of machine

31/3/23

Exchange Difference (Loss) = 4,00,000

Machine A/c Dr. To Foreign Currency Loan A/c	4,00,000	 4,00,000

Depreciation @10& = 82,00,000 x 10% = 8,20,000

Remaining Balance of Machine = 73,80,000

31/3/24

Exchange Difference (Gain) = 1,50,000

Deduct From Machines Book Value

Foreign Currency Loan A/c Dr. To Machine A/c	1,50,000	 1,50,000

Depreciation @10% on (73,80,000 – 1,50,000) = 72,30,000 x 10% = 7,23,000

Example 5:

Vsmart Ltd. took a loan of $75,000 on 1/4/22 when $1 = ₹ 78. Loan is utilized for working capital requirement loan is of 6 Years. Principal repayment equally every year.

1st year end - $1 = ₹ 81.30

2nd year end - $1 = ₹ 82.15

3rd year end - $1 = ₹ 82

4th year end - $1 = ₹ 81.50

5th year end - $1 = ₹ 81.90

6th year end - $1 = ₹ 82

Apply PARA 46 of AS 11:

Solution:

1) Initial Recognition:

Bank A/c Dr. To Foreign Currency Loan A/c	58,50,000	 58,50,000

2) Subsequent Measurement:

31/3/23 (Fist remeasure then pay installment)

FCMIT Difference A/c Dr. To FC Loan A/c ($75,000 x 3.30)	2,47,500	 2,47,500

FC Loan A/c	Dr.	10,16,250	
To Bank A/c ($12,500 x 81.30)			10,16,250

Foreign Currency Book Value = 50,81,250

Amortize FCMIT Difference in 6 Years = 2,47,500 / 6 = 41,250

Profit & Loss A/c	Dr.	41,250	
To FCMIT Difference A/c			41,250

Balance unamortised FCMIT = 2,06,250 (Dr. Balance)

31/3/24	31/3/25	31/3/26	31/3/27	31/3/28
$1 = ₹ 82.15	$1 = ₹ 82	$1 = ₹ 81.50	$1 = ₹ 81.90	$1 = ₹ 82
Prev. rate = 81.30	Prev. rate = 81.25	Prev. rate = 82	Prev. rate = 81.50	Prev. rate = 81.90
Loss = 0.85 x $62,500	Gain = 0.15 x $50,000	Gain = 0.5 x $37,500	Loss = 0.4 x $12,500	Loss = 0.10 x $12,500
Total Loss = 53,125	Total Gain = 7,500	Total Gain = 18,750	Total Loss = 10,000	Total Loss = 1,250
Loss added to FCMIT Difference	Deduct from FCMIT Difference	Deduct from FCMIT Difference	Added to FCMIT Difference	Added to FCMIT Difference
Revised FCMIT Difference = 2,59,375	Revised FCMIT Difference = 2,00,000	Revised FCMIT Difference = 1,31,250	Revised FCMIT Difference = 97,500	Revised FCMIT Difference = 50,000
Year = 5	Year = 4	Year = 3	Year = 2	Year = 1
P&L A/c = 51,875	P&L A/c amortised = 50,000	P&L A/c amortised = 43,750	P&L A/c amortised = 48,750	Fully amortised to P&L A/c = 50,000
Closing Balance of FCMIT = 2,07,500	Closing Balance of FCMIT = 1,50,000	Closing Balance of FCMIT = 87,500	Closing Balance of FCMIT = 48,750	

2. TRANSLATION OF FINANCIAL STATEMENTS OF FOREIGN OPERATIONS

AS 11 (Effect of Changes in Foreign Exchange Rates), classifies the foreign branches as:

- **INTEGRAL FOREIGN OPERATION:** The activities of which are an integral part of those of the reporting enterprise (i.e. Head Office). An integral foreign operation carries on its business as if it were an extension of the reporting enterprise's operations. (Example - Foreign Branch)

- **NON-INTEGRAL FOREIGN OPERATION:** The business of such branch is carried on in a substantially independent way. (Example – Foreign Subsidiary Co.)
  A non-integral foreign operation accumulates cash and other monetary items, incurs expenses, generates income and perhaps arranges borrowings, all substantially in its local currency.

TECHNIQUES FOR TRANSLATION:

(A) Integral Foreign Branch:

Items to be Translated	Translation at
Monetary Items (such as Debtors/creditors, Cash/Bank, Prepaid/Outstanding expense)	At Closing exchange rate
Non-Monetary items (such FA, Accumulated depreciation on FA, Investments etc.)	At Cost i.e., at the exchange rate on the date of purchase
Opening Stock	Opening exchange rate
Closing Stock	Closing exchange rate
Revenue nature items (Incomes and expenses)	Average rate
Goods sent to branch a/c and HO a/c	Actual balance in HO books

Any Exchange difference arising on the translation of the Branch Trial Balance should be transferred to Profit & Loss a/c of Branch.

(B) Non-Integral Foreign Branch:

1. **Balance Sheet items** i.e., Assets and Liabilities both Monetary and Non-monetary apply Closing exchange rate.
2. **Items of Income and Expenses** – At the actual exchange rates on the date of transactions. However, AS 11 allows average rate subject to materiality.
3. Any Exchange rate difference should be accumulated in a "Foreign Currency Translation Reserve" (FCTR).
4. FCTR shall be accumulated under Reserves & Surplus as a separate line item.
5. FCTR shall be reclassified to Profit and Loss account on Conversion from Non-Integral to Integral FO.
6. FCTR shall be reclassified to Profit and Loss account on sale/dispose of Non-Integral FO. However, if there is no disposal or sale of FO but only carrying amount is written off then no reclassification is allowed.
7. In the case of a partial disposal, only the proportionate share of the related accumulated exchange differences is included in the gain or loss.

How to Identify Non-Integral Foreign Operation?

The following are indications that a foreign operation is a non-integral foreign operation rather than an integral foreign operation:

I. While the reporting enterprise may control the foreign operation, the activities of the foreign operation are carried out with a significant degree of autonomy from those of the reporting enterprise.

II. Transactions with the reporting enterprise are not a high proportion of the foreign operation's activities.

III. The activities of the foreign operation are financed mainly from its own operations or local borrowings rather than from the reporting enterprise.

IV. Costs of labour, material and other components of the foreign operation's products or services are primarily paid or settled in the local currency rather than in the reporting currency.

V. The foreign operation's sales are mainly in currencies other than the reporting currency.

3. FORWARD EXCHANGE CONTRACTS (FEC)

Meaning:

- A FEC is an agreement between two parties where by one party agrees to buy or sell to other party an asset at future date for an agreed price.

- These contracts are over the counter in an unregulated market.

Accounting Treatment:

FEC have been classified into two types for the purpose of accounting treatment:

(1) Forward exchange contracts entered for managing risk (Hedging)

(2) Forward exchange contracts entered for trading or speculation.

Forward Exchange Contracts entered For Managing Risk (Hedging):

- Any forward premium/discount should be amortized/recognized over the tenor of contract in the profit and loss a/c.
- If the forward contract is cancelled or renewed, the profit or loss arising on cancellation or renewal is recognized in the profit & loss statement for the period.

Forward Exchange Contracts entered for Trading or Speculation:

- Here forward premium/discount should be ignored.
- At each balance sheet date the value of contract is marked to market, any gain or loss on the contract is recognized immediately.
- Upon sell of forward contract, any profit or loss to be recognized immediately in the statement of profit & loss.

Example 6: (Foreign Exchange Contracts Hedge)

Shubham Purchased an asset @35,000 on Credit for 3 months. Date of transaction is 1/3/23 (Payable on 1/6/23)

Exchange Rate on 1/3/23 is $1 = ₹ 80/-

Shubham is worried that $ may rise in future & hence Shubham entered into Hedge Contract with HDFC to buy after 3 months. Forward Rate is $1 = ₹ 82.35/-

Show Accounting in the books of Shubham.

Solution:

1) Shubham has purchased an Asset in $35,000. Therefore, this is a "Foreign Currency Transaction". Foreign Currency Transaction should be recorded initially @SPOT Rate i.e., 80/-

1/3/23

Asset A/c	Dr.	28,00,000	
To Foreign Creditors A/c ($35,000 x 80)			28,00,000

2) On the same day i.e., 1/3/23, Shubham entered into Foreign Exchange (Hedge) Contract to buy dollar @82.35 after 3 months.
   It means Shubham has fixed its loss at ₹ 2.35 x $35,000 = 82,250
   As per AS 11, this loss to Shubham is called as "Forward Premium" & it is to be amortised over the life of contract to P&L A/c
   82,250/3 = 27,417/-

3) **On 31st March 23, Shubham shall recognise 27,417/- loss as under: -**

Forward Premium A/c	Dr.	27,417	
To Foreign Creditor A/c			27,417
Profit & Loss A/c	Dr.	27,417	
To Forward Premium A/c			27,417

4) **On 30th April & 31st May: Shubham shall pass following entries**
   30/4/23

Forward Premium A/c	Dr.	27,417	
To Foreign Creditor A/c			27,417
Profit & Loss A/c	Dr.	27,417	
To Forward Premium A/c			27,417

31/5/23

Forward Premium A/c	Dr.	27,416	
To Foreign Creditor A/c			27,416
Profit & Loss A/c	Dr.	27,416	
To Forward Premium A/c			27,416

1/6/23

Foreign Creditor A/c	Dr.	28,82,250	
To Bank A/c			28,82,250

Example 7: (Speculation)

Shubham entered into a contract with broker to buy (Long) $10,000. Contract is made @ $1 = 80/-.
Actual SPOT Rate today is $79.75/-
Contract date is 1st Feb; Contract is for 3 months
Show the Accounting as per AS 11.
Suppose on 31/3, same contract for 1 month ca be made at $1 = 80.40/-
Actual rate on Contract expiry $1 = ₹ 81.25/-

Solution:

1) Shubham is doing speculation in dollars. Shubham feels that dollar may go up Shubham doesn't want to buy dollar physically.
2) **Accounting Entries:**

(a) On Contract Date: No Entry

(b) On Balance Sheet Date:

Foreign Exchange Contract Receivable A/c Dr. To Foreign Exchange Gain (P&L) A/c	4,000	4,000
Foreign Exchange Gain A/c Dr. To P&L A/c	4,000	4,000

(c) On Expiry Date / Settlement Date

Foreign Exchange Contract Receivable A/c Dr. To Foreign Exchange Gain (P&L) A/c	8,500	8,500
Cash/Bank A/c Dr. To Foreign Exchange Contract Receivable A/c	12,500	12,500

4. (MCQ's from ICAI Study Material)

1. As per AS 11 assets and liabilities of non-integral foreign operations should be converted at rate.
(a) Opening
(b) Average
(c) Closing
(d) Transaction

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

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

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

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

ANSWERS	1	2	3	4	5
	c	b	c	a	c

Student Notes:-

16

ACCOUNTING STANDARD – 12
ACCOUNTING FOR GOVERNMENT GRANTS

1. DEFINITIONS

- ***Government Grants*** are assistance by government in the form of transfers of resources to an entity in return for past or future compliance with certain conditions relating to the operating activities of the entity.
- Government here means Central and State Government as well as Local Bodies.
- Government Grant cannot be utilized to Pay Dividend amount to the shareholders.
- Tax Exemptions, Deductions are not considered as Grant.

2. RECOGNITION OF GOVERNMENT GRANTS

Recognition of Govt. Grant means recording the Grant either in P&L as Income immediately or any other special treatment as per AS 12.

Government grants, including non-monetary grants, should be recognised only when there is reasonable assurance that:

(a) The entity will comply with the conditions attaching to them; and

(b) The grants will be received.

If there is doubt in complying with the conditions and grant is already received, then treat it as liability:

Bank A/c Dr.
To Govt. Grant Liability A/c

Note: if the Grant is receivable in the current year for any previous year expenses already incurred. It should be recognised when it is receivable i.e. entry should be passed in current year only.

3. TYPES AND TREATMENT OF GOVERNMENT GRANTS

Sr. No.	Type of Grant	Treatment
1.	**Grants related to Income (Revenue Nature)** **Examples:** 1. Grant received to pay Salary 2. To Pay for medical facilities of Staff 3. To purchase vaccine for employees	**(a) (first method)** presented as an Income in the statement of profit and loss, either separately or under a general heading such as 'Other income'; **1)** Bank a/c Dr To Govt. Grant Income A/c **2)** Govt. Grant Income A/c Dr To P&L A/c (OR) **(b) (Second method)** deducted from Specific Expense A/c if grant received for incurring such Expense only: **1)** Bank a/c Dr To Govt. Grant A/c (When grant is received) **2)** Govt. Grant A/c Dr To Expense A/c (When Exp.is Incurred Grant is deducted from Expense)
2.	**Grant for Expenses or Losses already incurred.** **or** **Grant for immediate financial Support (Bailout Package)** **Ex.:** Grant received by Loss making companies	**<u>If Un-conditional Grant:</u>** Recognise directly to Profit and Loss a/c: 1) Bank A/c Dr. To Govt. Grant Income A/c 2) Govt. Grant Income A/c Dr. To Profit and Loss A/c **<u>If Conditional Grant</u>:** Deferred and Amortized over the period of fulfillment of conditions (Eg. Transfer to P&L Every year in parts and show un-amortised portion as Liability)
3.	**Grant in the form of Promoters' Contribution (just like capital investment)** **Example:** for working in Backward areas	Always transferred to <u>Capital Reserve</u> Bank A/c Dr. To Govt. Grant A/c Govt. Grant A/c Dr. To Capital Reserve A/c

4.	**Non-Monetary Grant (In Kind)** **Example:** Land received free of cost or at concessional price	**(a)** If acquired at Concessional Price, then Recognise the Grant at Actual **Price Paid** (acquired cost). Asset A/c Dr. To Bank A/c **(b)** If acquired at free of cost, then Recognise at **Nominal Value.** Nominal Value may be Rs. 1/- or 10/- Asset A/c Dr. To Capital Reserve A/c (Depreciation should not be charged here)
5.	**Grants related to Non-depreciable Assets** **Example:** Cash received for purchase of Land/stock	**Conditional Grant:** If it requires fulfillment of certain obligations then recognise in P&L a/c over the period of fulfilment of obligation. 1) Bank A/c Dr To Def. Govt. Grant A/c 2) Def. Govt. Grant A/c Dr. To P&L A/c (Amortised on systematic basis) **Unconditional Grant:** If it doesn't require any fulfillment of obligations in the future period then recognise the grant immediately in P&L a/c. Govt. Grant A/c Dr To P&L A/c
6.	**Grants related to depreciable assets** **Example:** Cash received to purchase machine/building/vehicle	**Option 1 – Deferred Income** Treat it as Deferred Income: 1) Bank A/c Dr To Def. Govt. Grant A/c DGG a/c shall be recognised in P&L a/c on a systematic basis over the useful life of the asset. 2) Def. Govt. Grant A/c Dr. To P&L A/c (Amortised on systematic basis) **Option 2 – Deduction from Cost** Should be presented by deducting the grant amount from Carrying Amount and depreciation

		shall be charged on net carrying amount after deduction. 1) Bank A/c Dr. To Govt. Grant A/c 2) Govt. Grant A/c Dr To PPE A/c

Example: (Non-Monetary Grant)
X Convent wishes to open a school in locality A. It applies to the State authority for grant of land. The State authority grants the land for construction of the purposes of the school construction. The market value of the land is Rs. 20 crores however, the authority provides the land at a nominal cost of Rs. 50 lakhs including cost of registration.
The State authority requires that free education must be provided to the poor children by way of reserving 20% of the seats in the school for such children. There is a reasonable assurance that X Convent has reason to believe it will meet the above stated condition attached to the grant.
Thus, X Convent needs to recognise the cost of the land at its acquisition cost of Rs. 50 lakhs.

4. REPAYMENT (REFUND) OF GOVERNMENT GRANTS

Refund of Govt. Grant is treated as Extra-ordinary item as per AS 5.

Following is the treatment of Refund:

If Grant was recognised directly in P&L as income	If Grant was recognised as Deferred Income	If Grant was recognised as reduction from Cost of Asset
Refund of grant is debited to Profit and loss a/c	Refund of grant will be debited to Deferred Grant A/c to the extent of balance available. Any remaining amount of refund will be debited to Profit and loss a/c	Refund of grant will be debited to the same Asset A/c
G. Grant Refunded A/c Dr. To Bank A/c Profit and Loss A/c Dr. To G. Grant Refunded	Deferred Grant A/c Dr. Grant Refund Exp. A/c Dr. To Bank A/c Profit and Loss A/c Dr. To G. Grant Refund Exp.	Asset A/c Dr. To Bank A/c Calculate Revised Depreciation on Asset for Further Years.

5. MCQ's from ICAI Study Material

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?
   (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

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
   (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

3. Which of the following is an acceptable method of accounting presentation for a government grant relating to an asset?
   (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

4. X Ltd. has received a grant of Rs. 20 crores for the purchase of a qualified machine costing Rs. 80 crores. X Ltd has a policy to recognise the grant as a deduction from the cost of the assets. 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:

(a) Rs. 10 crores

(b) Rs. 6 crores

(c) Rs. 2 crores

(d) Rs. 8 crores

5. X Ltd has received a grant of Rs. 20 crores for the purchase of a qualified machine costing Rs. 80 crores. 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 recognised in Profit and Loss Statement will be:

(a) Rs. 10 crores

(b) Rs. 6 crores

(c) Rs. 2 crores

(d) Rs. 8 crores

ANSWERS	1	2	3	4	5
	a	a	c	b	c

16

ACCOUNTING STANDARD – 15 EMPLOYEE BENEFITS

"Make each day your Masterpiece"

1. EMPLOYEE BENEFITS

1) Meaning:

- Any consideration payable by employer to its employees against services rendered by them for the employer.
- Such consideration is payable due to "contractual agreement" between employer and employee or sometimes due to informal practices as a result of "constructive obligation".
- AS 15 covers all types of employee benefits excluding share-based payments to employees.

Constructive Obligation:
An Obligation to pay that arises out of entity's actions rather than a contract. It may typically occur from past conduct (i.e. Past Practices/Commitments).

2) Types of Employee Benefits:

SHORT-TERM EMPLOYEE BENEFITS, which are expected to be settled within Twelve Months after the end of reporting period, such as wages, salaries etc.

POST-EMPLOYMENT BENEFITS, which are payable after the completion of employment such as gratuity, pension, other retirement benefits, post-employment life insurance and post-employment medical care etc.

OTHER LONG-TERM EMPLOYEE BENEFITS, which are payable beyond 12 months from the end of reporting period. E.g. Long Term Bonus plans

TERMINATION BENEFITS, which are payable to employees due to termination of their services before retirement. E.g. Retrenchment Compensation.

2. SHORT-TERM EMPLOYEE BENEFITS
(NO ACTURIAL ASSUMPTION & NO DISCOUNTING)

1) General Accounting Treatment:

Employee Benefit Expenses (Salary/Bonus) A/c Dr.
To Employee Benefits Payable A/c (Provision)

Employee Benefits Payable (Provision) A/c Dr.
To Bank A/c

2) Bonus in the form of Profit Sharing:

It is also considered as an employee benefit expense if payable on satisfaction of required conditions.
It is payable as a defined percentage of profit earned by the employer.

3) Leaves Compensation (Paid Leaves or Compensating Absence):

Employer compensates to employees for their extra services provided by them during the leave period. Compensation can be provided in the form of either Cash or Extra leaves in the next period.

<table>
<tr><th colspan="2">Accumulating Paid Leaves</th><th>Non-Accumulating Paid Leaves</th></tr>
<tr><td colspan="2">Unused leaves can be carried forward to the next year</td><td>Unused leaves can-not be carried forward to the next year</td></tr>
<tr><td>Vesting Leaves
(Payable in cash)</td><td>Non-vesting leaves (payable in the form of excess leaves in next year)</td><td rowspan="2">No Accounting</td></tr>
<tr><td>Here employee is eligible for cash payment against unused leaves. Hence 100% cash expense for unused leaves are recognised.

Expenses =
Total Unused Leaves
X Avg. Salary Per Day</td><td>Here employee is eligible for extra leaves in the form of carried forward of unused leaves.
Here it is not necessary that employee may utilize 100% excess leaves allowed, hence employee expense is recognised based on estimated leaves to be utilized.

Expenses =
No. of Employees expected to utilize the unused leaves</td></tr>
</table>

	X No. of unused leaves expected to be utilized by each employee X Avg. Salary Per Day	
Avg. Salary Per Day = Total Annual Salary ÷ No. of Working Days		

Example 1:

Annual Salary – 12,00,000; Total Working Days – 300; Leaves allowed in a year – 12 days; Leaves actually taken by employee – 9 days. Unused leaves will be settled in form of cash.

Solution

1. Avg. Salary Per Day -> 12,00,000 ÷ 300 = 4,000/-
2. Cash Payable for Unused leaves -> 4,000 x 3 = 12,000/-
3. Total Employee Benefit Expense to be booked -> 12,12,000/-

Salary A/c Dr.	12,12,000	
To Salary Payable A/c		12,12,000
Salary Payable A/c Dr.	12,12,000	
To Bank A/c		12,12,000

Example 2:

Annual Salary – 12,00,000; Total Working Days – 300; Leaves allowed in a year – 12 days; Leaves actually taken by employee – 9 days. Unused leaves will be settled in next year in the form of extra leaves. It is expected that 2 out of 3 unused leaves will be utilized. Suppose, employee utilized 2 days next year out of 3 days allowed.

Solution

Current Year	Next Year
No. of Days worked = 291 days Avg. Salary Per Day -> 12,00,000 ÷ 300 = 4,000 Expected Value of Unused leaves to be utilized: 4,000 x 2 = 8,000 Total Employee Benefit Expense to be booked: 12,08,000 Salary A/c Dr. 12,08,000 To Salary Payable A/c 12,08,000 Salary Payable A/c Dr. 12,00,000 To Bank A/c 12,00,000	No. of Days worked = 286 days But employee will get full salary of 12,00,000 Salary Payable A/c Dr. 8,000 Salary A/c Dr. 11,92,000 To Bank A/c 12,00,000

Worked More days – Recognised Salary for more days	Worked lesser days – Recognised Salary for lesser days

Example 3:

An enterprise has 100 employees, who are each entitled to five working days of leave for each year. Unused leave may be carried forward for one calendar year. The leave is taken first out of the current year's entitlement and then out of any balance brought forward from the previous year (a LIFO basis). At 31 December 20X4, the average unused entitlement is two days per employee. The enterprise expects, based on past experience which is expected to continue, that 92 employees will take no more than five days of leave in 20X5 and that the remaining eight employees will take an average of six and a half days each.

How much is the expected liability due to leaves?

Ans.:

The enterprise expects that it will pay an additional 12 days of pay as a result of the unused entitlement that has accumulated at 31 December 20X4 (one and a half days each, for eight employees). Therefore, the enterprise recognises a liability, as at 31 December 20X4, equal to 12 days of pay.

3. POST-EMPLOYMENT EMPLOYEE BENEFITS

1) Types of Post employment benefits:

a) **Defined Contribution Plans (DCP):** Fixed contribution by employer to the specific fund such as EPF.

b) **Defined Benefit Plans (DBP):** Fixed Benefit (final amount payable) is payable by employer directly to employee in form of contributing variable amount every year to the fund.

DIFFERENCE BETWEEN DCP AND DBP

Basis of Difference	Defined Contribution Plans (DCP)	Defined Benefit Plans (DBP)
Meaning	Entity pays fixed contributions into a separate entity (a fund) and will have no legal or constructive obligation to pay further contributions.	Post-employment benefit plans other than defined contribution plans (i.e. No Fixed Contribution)
Actuarial & Investment Risk (Benefits will be more/less than expected)	Risk in substance on the Employee	Risk in substance on the entity.

Examples	Provident Fund Contribution by employer	Gratuity
Actuarial Assumptions	Not Required	Required
Discounting	Not Required unless it is payable beyond 12 months.	Always Required
Accounting	Same as short term employee benefits	Apply "Projected Unit Credit" Method

2) Accounting For Defined Benefit Plans: (Under Post Employment Benefit and Long-Term Employment Benefits)

Scope of Accounting:

a) Calculation of Defined Benefit Obligation (DBO) A/c and related Expenses
b) Calculation of Plan Assets A/c and related Incomes
c) Calculation of Actuarial Gains/Losses on DBO and Plan Assets
d) Presentation of DBO and Plan Asset in Balance Sheet
e) Presentation of Expenses (Incomes) in Profit and Loss Statement

RECOGNITION OF DEFINED BENEFIT OBLIGATIONS (LIABILITY)	
Important Steps to calculate annual Defined Benefit Obligation	**Step 1:** Calculate Expected Benefits to be paid to employees Expected Final Salary × Benefit (%) × No. of Years of Service **Step 2:** Allocate the Benefits to each year of Service (Attributed Benefits) Step 1 ÷ No. of Years of Service **Step 3:** Calculate Current Service Cost (CSC) using discount rate. PV of Attributed Benefits (PV working in upward mode) Current Service Cost (CSC) A/c Dr. (P&L) To DBO Payable A/c **Step 4:** Calculate Interest Cost on Opening Balance of DBO Payable using same discount rate. Interest Cost A/c Dr. (P&L) To DBO Payable A/c
Actuarial Gains or Loss in DBO liability	Due to change in financial and demographic assumptions of actuary or due to change in final expected salary, no. of years of services, DBO liability shall be remeasured with new assumptions.

	Increase in DBO Liability = Actuarial Loss Actuarial Loss (P&L) A/c Dr. To DBO Payable A/c Decrease in DBO Liability = Actuarial Gain DBO Payable A/c Dr. To Actuarial Gain (P&L) A/c Dr.
Past Service Cost (PSC)	If there is a modification in Defined Benefits announced by employer which results in increase of benefits for employee (i.e. additional benefits) then DBO Liability shall be increased accordingly. **PSC is divided into two parts:** **(a)** Amortised Past service cost - which is to be **recognized immediately** to the extent benefits are **already vested.** **(b)** Unamortised Past Service cost (UPSC)– to be recognized on **straight line basis** over the remaining period until the benefits are vested. Past Service Cost (P&L) A/c Dr. Unamortised PSC A/c Dr. To DBO Payable A/c
Curtailment and Settlement	Curtailment means cancellation of Defined Benefits of employees. Settlement means providing compensation to employees against cancellation of benefits. Curtailment shall reduce the liability as under: DBO Payable A/c Dr. To Unamortise PSC A/c (proportionate reversal) To Bank A/c Dr. To Gain on Settlement A/c (P&L)
Payment of Benefits to Employee	Whenever the employee retires, he/she will be eligible for benefits. DBO Payable A/c Dr. To Bank A/c Dr.

RECOGNITION OF PLAN ASSETS (INVESTMENT for DBO)	
Meaning	Investment made by Employer for meeting DBO liability. It is always recognised at Fair Value.

Contribution to Plan Assets	Contribution to Plan Asset means making Investment as per actuarial assumption under: Plan Assets A/c Dr. To Bank A/c (contribution is paid in beginning of year or mid of year or end of year)
Benefits Paid out of Plan Assets	When Employee is paid benefits, plan assets are realised as under: Bank A/c Dr. To Plan Assets A/c (Plan assets are realised in beginning of year or mid of year or end of year)
Expected Return on Plan Assets Plan Asset A/c Dr. To Exp. Return (P&L)	Interest Rate (%) X Balance of Plan Asset = Expected Return (Take same discount rate of DBO if separate rate is not given) If contribution and benefit <u>is made at end of year</u> Opening Balance of Plan Asset x Interest Rate (%) If contribution and benefit <u>is made at beginning of year</u> (Opening Balance of Plan Asset + Contribution Made – Benefits Paid) x Interest Rate (%) If contribution and benefit <u>is made at mid of year</u> Expected Return 1 - Opening Plan Assets x Interest (%) <u>(+) Expected Return 2</u> - Net Contribution x Six Monthly Interest (%) (=) Total Return Six Monthly Rate of Expected Return as under: $[\sqrt{1 + annaul\ rate} - 1] \times 100$ If nothing is specified in question always assume that contribution is made, and benefits are paid at end of the year.
Closing Balance of Plan Assets	Always at Fair Value provided in Question
Actuarial Gain/Loss on Plan Assets	Any Difference in Plan Asset A/c is treated as Actuarial Gain or Loss and transferred to Profit and Loss A/c Plan Asset A/c Dr. Actuarial Loss (P&L) Dr. To Actuarial Gain (P&L) To Plan Asset A/c

Calculation of DBO Payable and Plan Asset

DBO Payable		Plan Asset	
Opening Balance of DBO	XXX	Opening Balance of Plan Asset	XXX

(+) Current Service Cost (CSC)	XXX	(+) Expected Return	XXX
(+) Interest Cost	XXX	(+) Contribution to Plan Asset	XXX
(+) Past Service Cost	XXX	(-) Payment of Benefits	XXX
(-) Curtailment of Benefits	XXX	(+/-) Actuarial Gain/(loss)	XXX
(-) Payment of Benefits	XXX	Closing Balance of Plan Asset	XXX
(+/-) Actuarial Loss/(Gain)	XXX		
Closing Balance of DBO	XXX		

Presentation in Financial Statements

BALANCE SHEET		STATEMENT OF PROFIT AND LOSS
Closing Balance of DBO	XXX	**Items of P&L:**
(-) Closing Bal. of Plan Asset	XXX	Employee Benefit Expenses
(-) Unamortised PSC	XXX	• Current Service Cost under Employee Benefit Exp.
Net Defined Liability/(Asset)	XXX	• Past Service Cost
		• Gain on Curtailment
		• Actuarial Gain/Loss on DBO
		• Actuarial Gain/Loss on Plan Assets
		Finance Cost
		• Net Interest Cost under Employee Benefit Exp.
		(Net Interest Cost means Interest Cost on DBO less Expected Return on Plan Asset)

Other Important Points:

1. The discount rate shall be determined by reference to market yields at the end of reporting period on Government Bonds.

2. **Current/Non-Current Distinction:**

   This Standard does not specify whether an entity should distinguish current and non-current portions of assets and liabilities arising from post-employment benefits.

Example 4: (on Define Benefit Obligation)

An Entity announced Defined Bonus plan for its 50 employees. Bonus would be payable after serving 5 years (Long Term Benefit). The bonus amount would be 8% of Last drawn Salary after 5 years for each year of service. Discount Rate = 10 % p. a. Current Avg. Salary p.a. per Employee = 6,00,000/-. Salary Inflate Rate = 7 % p.a.

Show Accounting as per As 15.

Solution :-

Defined Benefit Plan = Defined Bonus = 8% of Salary for Each year of Service.

Step - 1:

Calculate Total Defined Benefit

Current salary	6,00,000/-
Expected Salary after 5 years Per Employee	(6,00,000 × 1.07) × 1.07 × 1.07 × 1.07 = 7,86,478/ -
Estimated Defined Benefit	7,86,478 X 8% X 5 YEARS X 50 No.
	1,57,29,552

Step – 2:

Calculate Allocated Benefits per year

Allocated Benefit	1,57,29,552 ÷ 5
	31,45, 901/-

Step - 3:

Calculate Current Service Cost (CSC)

Year	Allocated Benefits	PVF @10%	CSC
1	31,45,910	0.683	21,48,657
2	31,45,910	0.751	23,62,578
3	31,45,910	0.826	25,98,523
4	31,45,910	0.909	28,59,634
5	31,45,910	1	31,45,910

Step - 4

Calculation of Interest Cost

	1st	2nd	3rd	4th	5th
Opening Balance	0	21,48,657	47,26,101	77,97,234	114,36,591
Int. Cost (10 %)	0	2,14,866	4,72,610	7,79,723	11,47,051
CSC recognised at the End	21,48,657	23,62,578	25,98,523	28,59,634	31,45,910
Closing Bal	21,48,657	47,26,101	77,97,234	1,14,36,591	1,57,29,552

Journal Entry

1st Year	Current Service cost a/c Dr.	21,48,657
	To Defined Benefit Obligation Payable (DBO) A/c	21,48,657
2nd year	Current Service Cost A/c Dr.	23,62,578 (P&L)
	Interest Cost A/c Dr.	21,48,657 (P&L)
	To DBO Payable A/c	25,77,444

Example 5: (on Define Benefit Obligation)

A lump sum gratuity, equal to 1% of final salary for each year of service, is payable on termination of service. The salary in year 1 is Rs. 10,000 and is assumed to increase at 7% (compound) each year resulting in Rs. 13,100 at the end of year 5. The discount rate used is 10% per annum. Shows how the obligation builds up for an employee who is expected to leave at the end of year 5, assuming that there are no changes in actuarial assumptions.

SOLUTION: **(Amount in Rs.)**

Computation of benefits attributed to the current and prior years:

Year	1	2	3	4	5
Benefit attributed to:					
- Prior year	0	131	262	393	524
- Current year (1% of final salary)	131	131	131	131	131
- Current and prior years	131	262	393	524	655

Computation of obligation for an employee:

Year	1	2	3	4	5
Opening Obligation	-	89	196	324	476
Interest at 10%	-	9	20	33	48
Current service cost (see note 2)	89	98	108	119	131
Closing Obligation (see note 1)	**89**	**196**	**324**	**476**	**655**

Note 1

Closing obligation

Year	1	2	3	4	5
Gratuity attributable	131	262	393	524	655
Payable after (years)	4	3	2	1	0
Discounting factor	.683	.751	.826	.909	1
PV	**89**	**196**	**324**	**476**	**655**

Note 2

Current Service Cost

Year	1	2	3	4	5
Gratuity of current year	131	131	131	131	131
Payable after (years)	4	3	2	1	0
Discounting factor	.683	.751	.826	.909	1
PV	**89**	**98**	**108**	**119**	**131**

Example 6: (Plan Assets)

On 1.4.20X1, the fair value of plan assets is Rs.10,000. On 30.9.20X1 it paid benefits of Rs. 1,500 and received contributions of Rs. 4,500. On 31.03.20X2, fair value of plan assets is Rs.15,000 and PV of obligation was Rs. 14,972. Actuarial losses on obligation was Rs. 60 on 31.03.20X2.

Find the net actuarial gain/losses on 31.03.20X2 based on the following estimates:

Interest and dividend income	9.00%
Realised and unrealized gain on plan assets	1.50%
Administration costs	(1.00%)

Solution

- Annual Expected Return = 9.50%

- Six Monthly Rate = Squar Root of [(1 + 0.095) – 1)] × 100 = 4.64 %

Plan Assets A/c

01/04	To Balance b/f	10,000	30/09	By Bank	1,500
30/09	To Bank a/c	4,500			
31/03	To Expected Return 10,000 × 9.5% 3,000 x 4.64%	 950 139			
31/03	To Actuarial Gain	911	31/03	By Balance c/d	15,000

Example 7: (Plan Assets)

FY 23-24

1/4/23	Opening Balance of Plan Assets	5,00,000/-
1/4/23	Contribution to Plan Assets	1,00,000/-
1/4/23	Benefits Paid out of Plan Assets	1,50,000/-
	Expected Return	12% p.a.
	Fair Value on 31/03/24	5,20,000/-

Solution –

Plan Assets A/c

¼ To Balance b/d	5,00,000	¼ By Bank (Benefits paid)	1,50,000
¼ To Bank A/c	1,00,000		
31/3 To Expected Income (Income @ 12% on 4,50,000)	54,000		
31/3 To Actuarial Gain (P&L)	16,000	31/3 By Balance c/d	5,20,000

Actual Return for the year	Expected Return + Actuarial Gain /loss
	54,000 + 16,000
	70,000

Example 8:

Assume Same Example 4 above, with following Changes:

Date of Contribution made Benefits paid is 31/3/24. Prepare Plan Asset A/c

Solution –

Plan Asset A/c

¼ To Balance	5,00,000	31/3 By Bank (Benefits)	1,50,000
31/3 To Expected Return (12% on Opening)	60,000		
31/3 To Bank A/c	1,00,000		
31/3 To Actuarial Gain (b/f)	10,000	31/3 By Balance	5,20,000

Actual Return	60,000 + 10,000
(Expected Return + Actuarial Gain)	70,000/-

Example 9:

Assume Same Example 4 as above But Date of Contribution & Benefits paid are on 1/10. Prepare Plan Asset a/c

Expected Return	12% p.a. Annual Rate
Six Monthly Compound Rate	[(≤1+Annual rate)]-1]×100
	[(≤ 1+0.12) -1] x100
	5.83% Six monthly Compounded

Plan Asset A/c

¼ To Balance	5,00,000	31/3 By Bank (Benefits)	1,50,000
1/10 To Bank A/c	1,00,000		
31/03 To Expected Return 5,00,000 x 12% = 60,000 (50,000) x 5.83% = (2915)	57,085		
31/3 To Actuarial Gain (b/f)	12,915	31/3 By Balance	5,20,000

Actual Return	57,085 + 12,915
(Expected Return + Actuarial Gain)	70,000/-

Example 10:

An enterprise operates a pension plan that provides a pension of 2% on final salary for each year of service. The benefit will be vested after 5 years of service. On 1.1.2005, the enterprise improves the pension to 2.5% of the final salary for each year of service starting from 1.1.2001 at the date of improvement the Present Value of additional benefits for service from 1.1 .2001 to as follows:

- Employees with more than 5 years of service at 1.1.2005 Rs. 2,00,000
- Employees with less than 5 years of service Rs. 1,20,000
  (Average period until vesting = 3 years)

Suggest the accounting treatment.

Solution

1) Amortised PSC means additional Benefits payable to employees with more than 5 years of Service, hence 2,00,000 it is to be immediately Recognised in P&L.
2) Unmortised PSC mean additional Benefits payable to employees with Less than 5 years i.e. Unvested Benefits of Rs 1,20,000 is to recognised in next 3 years.

Example 11:

An enterprise discontinues a business segment and the employees of this segment will earn no further benefits. This is curtailment without a settlement. Immediately before the curtailment the details were.

	Before Curtailment	After Curtailment
PV of obligation	1,000	900
FV of plan assets	820	820
Unrecognized past service cost	50	45

The curtailment reduces the obligation to Rs. 900 and URPSC to Rs.45. Suggest accounting treatment.

Solution:

DBO Payable A/c Dr.	100	
To Un-amortised PSC A/c		5
To Gain on Curtailment A/c		95(P&L A/c)

4. TERMINATION BENEFITS

An entity is required to recognise a liability and expense for termination benefits in the year of announcement of Termination Plan.

Amount paid for Termination of Employment	Termination Benefit Exp A/c Dr. (P&L) To Termination Benefits Payable A/c
Amount paid to receive services in future	It's a Normal Salary benefit

Example on Termination Benefits:

As a result of a recent acquisition, an entity plans to close a factory in ten months and, at that time, terminate the employment of all of the remaining employees at the factory. Because the entity needs the expertise of the employees at the factory to complete some contracts, it announces a plan of termination as follows:

Each employee who stays and renders service until the closure of the factory will receive on the termination date a cash payment of Rs 30,000. Employees leaving before closure of the factory will receive Rs 10,000.

There are 120 employees at the factory. At the time of announcing the plan, the entity expects 20 of them to leave before closure. Therefore, the total expected cash outflows under the plan are Rs. 3,200,000 (ie 20 × Rs10,000 + 100 × Rs 30,000). As required by paragraph 160, the entity accounts for benefits provided in exchange for termination of employment as termination benefits and accounts for benefits provided in exchange for services as short-term employee benefits.

Termination benefits

The benefit provided in exchange for termination of employment is Rs. 10,000. This is the amount that an entity would have to pay for terminating the employment regardless of whether the employees stay and render service until closure of the factory, or they leave before closure. Even though the employees can leave before closure, the termination of all employees' employment is a result of the entity's decision to close the factory and terminate their employment (i.e. all employees will leave employment when the factory closes). Therefore, the entity recognises a liability of Rs. 1,200,000 (i.e. 120 × Rs. 10,000) for the termination benefits provided in accordance with the employee benefit plan at the earlier of when the plan of termination is announced and when the entity recognises the restructuring costs associated with the closure of the factory.

Benefits provided in exchange for service

The incremental benefits that employees will receive if they provide services for the full ten-month period are in exchange for services provided over that period. The entity accounts for them as short-term employee benefits because the entity expects to settle them before twelve months after the end of the annual reporting period. In this example, discounting is not required, so an expense of Rs. 200,000 (i.e. Rs. 2,000,000 ÷ 10) is recognised in each month during the service period of ten months, with a corresponding increase in the carrying amount of the liability.

5. (MCQ's from ICAI Material)

1. **Gratuity and Pension would be examples of:**
   - (a) Short-term employee benefits
   - (b) Long-term employee benefits
   - (c) Post-employment benefits.
   - (d) None of the above.

2. **Non-accumulating compensating absence is commonly referred to as:**
   - (a) Earned Leave
   - (b) Sick Leave
   - (c) Casual leave
   - (d) All of the above

3. **The plans that are established by legislation to cover all enterprises and are operated by Governments include:**
   - (a) Multi-Employer plans
   - (b) State plans
   - (c) Insured Benefits
   - (d) Employee benefit plan

4. **Best estimates of the variable to determine the eventual cost of postemployment benefit is referred to as**
   - (a) Employer's contribution
   - (b) Actuarial assumptions
   - (c) Cost to Company
   - (d) Employee's contribution

5. **Actuarial gains / losses should be:**
   - (a) Recognised 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

ANSWERS	1	2	3	4	5
	c	c	b	b	c

Student Notes:-

CA NOTES COMMUNITY NETWORK

Click on Icon	QR CODE	LINK
Join what's App group		CLICK HERE
Join Telegram Channel		CLICK HERE
Subscribe On Youtube		CLICK HERE
Follow us On Instagram		CLICK HERE

BE A PART OF CNC FAMILY

CNC – CA NOTES COMMUNITY

Mail at (for complaints/feedback) – canotescommunity@gmai.com

28 ACCOUNTING STANDARD – 17
SEGMENT REPORTING

Quote:

"Make Improvements, Not Excuses. Seek Respect, Not Attention"

1. WHY SEGMENT REPORTS ?

This standard requires entity to prepare a Segment wise report of entire business so that the stakeholders can understand and evaluate the performance of business on segment wise.

- Segment report is not a part of Financial Statements.
- If a financial report contains both the consolidated and Standalone financial statements, segment information is required **only as per the consolidated financial statements.**

2. REPORTABLE SEGMENTS

Those segments of entity for which financial information is required to be disclosed separately along with the financial statements. Any Segments will be considered as reportable when any one of the following criteria is fulfilled:

(a) If Revenue (Sales) of a segment is equal to or more than 10% of the combined revenue (sales) of all segments.

Revenue means both External Revenue from Outside Customers and Internal Revenue from inter segment sales.

(b) If profit or loss of that segment is equal to or more than 10% of the combined result of all segments.

Combined Result means higher of:

(i) Combined Profit of all segments in Profits

(ii) Combined Loss of all segments in Losses

(c) If Assets of that segment are equal to or more than 10% of the combined Assets of all Segments.

Minimum 75% criteria:

If the total external revenue reported by operating segments constitutes less than 75% of the entity's revenue, additional operating segments should be identified as reportable segments (even if they do not meet the criteria) until at least 75% of the entity's revenue is included in reportable segments.

(i.e. External revenue of reportable segments must be ≥ 75% of the total external revenue of the entity)

Choice of Management:
Entity can report any additional segment as reportable segment even though it does not meet the above criteria.

Non-reportable segments:
All remaining segments which are not reportable separately should be combined and disclosed as "Other Segments" in Segment Report.

3. IDENTIFY BUSINESS OR GEOGRAPHICAL SEGMENTS

A **business segment** is a part of a company that focuses on offering a specific product or a group of related products or services. This part of the company faces different risks and makes different profits compared to other parts of the company. Factors that should be considered to identify a business segment are:

1. Is the Nature of these Products or Services different from Other Products or Services?
   (iPhone segment is different from MacBook Segment)
2. Is the process of production of these products or services different from others?
   (Tata produces CARs but Electric Car production process is different from Petrol and Deisel Cars production)
3. Are the customers for these products or services different from other customers?
   (Nike has different class of customers, Professional Athletes and Casual Customers. Both customers will have different needs hence products can be customised according to their need)
4. Are these products or services sold or delivered differently from other products or serives?
   (Amazon has two distribution channels, Some products are directly shipped from its own warehouse and some are shipped from third party sellers)
5. Different Regulatory laws for different products or servies?
   (Kotak Group has different segments with different regulatory laws such as Kotak Securities with SEBI regulations and Kotak Bank with RBI Regulations)

A **geographical segment** is a part of a company that operates in a specific area, like a country or region, and it faces different risks and profits compared to other areas. To understand a geographical segment, consider these factors:

1. **Economic and Political Conditions:**
   Example: McDonald's operates in many countries. In a country like the United States with a stable economy and political environment, McDonald's might face fewer challenges compared to a country like India, which is different economy and price sensitive including different political conditions. So the planning and decision making could be different.

2. **Relationships Between Areas:**

   Example: Reliance operates its petrochemical plants in Jamnagar (Gujarat) while having significant business interests in Mumbai (Maharashtra) where its corporate headquarters are located. The strong economic ties and logistical connectivity between these two regions facilitate smooth operations and efficient supply chain management.

3. **Proximity of Operations:**

   Example: A Sports company like Adidas has many stores within major cities such as Mumbai or Pune. Being close to each store helps them manage inventory and respond quickly to customer needs. Now they have their stores in Northern and Southern India also, but connecting these stores with Pune and Mumbai stores would not be possible due to time constraints.

4. **Special Risks in a Particular Area:**

   Example: A tourism company have operations in India and Japan. It needs to consider earthquake risks in Japan. But in India, it does not face the same level of concern for such events.

5. **Exchange Control Regulations:**

   Example: A multinational company like Nestlé, operating in India, needs to deal with the Indian government's strict regulations on currency exchange and conversions into their local currency. This can complicate their financial operations compared to a country with more relaxed currency controls such as Singapore.

6. **Underlying Currency Risks:**

   Example: Tata Consultancy Services (TCS) earns a significant portion of its revenue from clients in the United States and Europe. As a result, it faces underlying currency risks due to fluctuations in the Indian Rupee against the US Dollar and Euro. These currency risks can affect its profitability, and the company uses hedging strategies to mitigate these risks.

Important Notes:

1) A segment may engage in business activities for which it has yet to earn revenues, for example, start-up operations may be business or geographical segments before earning revenues.
2) Corporate Headquarters cannot become the segment.
3) Two or more segments may be aggregated into a single segment if the segments have similar economic characteristics (i.e. similar profit margin) with similar nature of Products & Services or types of customers.

4. PRIMARY AND SECONDARY REPORTING

1) Either Business Segments or Geographical Segments can become the Primary Reporting and the other one becomes the Secondary Reporting.
2) If a company's risks and profits are mainly influenced by the different products or services it offers, it should primarily report information by business segments (like separating results for its different product lines).

   For example, Tata Motors might report separately for its passenger vehicles, commercial vehicles, and electric vehicles because each segment has different risks and returns.

3) On the other hand, if a company's risks and profits are mostly affected by the different regions or countries where it operates, it should primarily report information by geographical segments. For instance, Infosys might report its financials separately for operations in India, North America, and Europe, because each region has its own economic environment, regulatory landscape, and market conditions that influence the company's performance.

4) Also, it can be decided based on how the Board of Directors and Chief Executive Officer (CEO) of the entity reviews the financial information either product wise or geographic location wise.

5. ELEMENTS FOR SEGMENT REPORTING

SEGMENT REVENUE	*Aggregate of –* (a) Revenue Directly attributable to Segment (b) Enterprise Re (c) venue which is allocated to Segment on reasonable basis (d) Inter Segment Revenue (Transactions with other Segments) **Does not include** • Extraordinary items (defined in AS 5) • Interest or Dividend Income (Except Operation of segment is primarily of financial nature such as Banks and Financial Institutions) • Gains on Sale of Investments or Extinguishment of Debts (Except Operation of segment is primarily of financial nature)
SEGMENT EXPENSE	*Aggregate of –* (a) Expense Directly attributable to Segment resulting from Operating activities of segment. (b) Enterprise Expense which is allocated to Segment on reasonable basis (c) Inter Segment Expenses (Transactions with other Segments) **Does not include** • Extraordinary items (defined in AS 5) • Interest Expenses (Except Operation of segment is primarily of financial nature) • Losses on Sale of Investments or Extinguishment of Debts (Except Operation of segment is primarily of financial nature) • Income Tax Expenses • General Adm. Expenses, Head Office Exp. and Other Exp. incurred at enterprise level and related to entity as whole. **Important Point-** In case interest is capitalized to the cost of inventories as per AS 16 and such inventories are considered part of segment assets of a particular segment, then the interest should be considered as a segment expense.

SEGMENT RESULT	SERGENT REVENUE LESS SEGMENT EXPENSES
SEGMENT ASSETS	Operating Assets employed by the Segments in its operating activities (Directly Attributable or Allocated) Investments, Advances Receivables, Loans or Other related Assets are also included only and only when Interest and Dividend Income are part of Segment Results. **Does not include-** Income Tax Assets (TDS, Advance Tax, Deferred Tax Asset) Assets used for Head Office or General Purpose
SEGMENT LIABILITIES	Operating Liabilities of the Segments (Directly Attributable or Allocated) Borrowings, Loans Payables are also included only and only when Interest Expenses on above are part of Segment Results. **Does not include-** Income Tax Liabilities (Deferred Tax Liability, Current Tax Liability) Loans and Liabilities used for Head Office or General Purpose **Example:** Working Capital Loan taken for Particular Segment shall be part of Segment Liabilities but Other Long-Term Loans may not be included if taken for whole company.
ACCOUNTING POLICIES	Segment information should be prepared in conformity with the accounting policies adopted for preparing and presenting the financial statements of the enterprise as a whole. However, AS 17 does not prohibit the disclosure of additional segment information that is prepared on a basis other than the accounting policies adopted for the enterprise financial statements.

6. PRIMARY AND SECONDARY REPORTING DISCLOSURES

PRIMARY REPORTING INFORMATION:

An enterprise should disclose the following for each reportable segment:

- **(a)** Segment Revenue (Separately information for External and Internal Revenue)
- **(b)** Segment Result.
- **(c)** Total carrying amount of Segment Assets.
- **(d)** Total amount of Segment Liabilities.
- **(e)** Capital Expenditure incurred during the period (PPE and Intangible assets).
- **(f)** Depreciation and Amortisation during the Period.

(g) Other significant non-cash expenses.

An enterprise should present a Reconciliation between the Reportable Segments and Financial Statements.

- Segment Revenue should be reconciled to Enterprise Revenue;
- Segment Results should be reconciled with Enterprise Net Profit or Loss;
- Segment Assets should be reconciled to Enterprise Assets; and
- Segment Liabilities should be reconciled to Enterprise Liabilities.

SECONDARY REPORTING INFORMATION:

If primary format of an enterprise for reporting segment information is business segments, it should also report the following information considering geographical area wise:

1. Segment wise Revenue from External Customers: Those geographical segments whose external revenue is 10% or more of the total enterprise revenue.
2. Segment wise Assets: Those geographical segments whose assets value are 10% or more of the total enterprise assets and Capital Expenditure incurrent during the year.

If primary format of an enterprise for reporting segment information is Geographic segments, it should also report the following information considering Product/Service wise:

1. Segment wise Revenue from External Customers: Those business segments whose external revenue is 10% or more of the total enterprise revenue.
2. Segment wise Assets: Those business segments whose assets value are 10% or more of the total enterprise assets and Capital Expenditure incurrent during the year.

STEP 4 – PREPARE A SEGMENT REPORT (DISCLOSURES)

PRIMARY SEBMENT REPORT (Assuming Business Segments)

Particulars	Segment 1 (Reportable)	Segment 2 (Reportable)	Inter Segment Eliminations	Total
1. Segment Revenue & Results:				
Segment Revenue (Gross)				
Domestic:	XXX	XXX		XXX
Exports:	XXX	XXX		XXX
Total External Sales:	XXX	XXX	-	XXX
Inter Segment Sales:	XXX	XXX	(XXX)	XXX
Total Revenue	XXX	XXX	(XXX)	XXX
(-) Segment Expenses	XXXX	XXXX		XXXX
Segment Results (Profits/Losses)	XXX	XXX		XXX
(+) Unallocated Incomes less Expenses	-	-		XX
Net Profit before Interest & Tax				XXX

(-) Interest & Other Finance Cost Net Profit before Tax (-) Tax Expenses (Current +/- Deferred) Profit After Tax (Entire)				XXX XXX XXX XXX
2. **Segment Assets & Liabilities**				
(i) Assets:				
Non – Current Assets:	XXXX	XXXX		XXXX
Current Assets	XXXX	XXXX		XXXX
Total Segment Assets	XXXX	XXXX		XXXX
Unallocated Assets	-	-		XXX
Total Assets (Entire)	-	-		XXXX
(ii) Equity and Liabilities:				
Segment Liabilities	XXX	XXX		XXXX
Unallocated Liabilities	-	-		XXX
Total Liabilities	XXXX	XXXX		XXXX
Share Capital				XXXX
Reserves & Surplus				XXXX
Total Equity and Liabilities (Entire)				XXXX
3. **Other Information:**				
Capital Expenditure During the Year	XXX	XXX		XXX
Depreciation & Amortisation	XXX	XXX		XXX
Other Non-Cash Expenses	XXX	XXX		XXX

SECONDARY SEGMENT INFORMATION (Assuming Geographical Segment Wise)

Geographical Information:	Domestic	Foreign Country 1	Foreign Country 2	Total
Total Revenue	XXX	XXX	XXX	XXX
Total Assets	XXX	XXX	XXX	XXX
Total Capital Expenditure During the Year	XXX	XXX	XXX	XXX

18 ACCOUNTING STANDARD – 18 RELATED PARTY DISCLOSURES

Why AS 18?

It is quite probable that a related party relationship may have an effect on the profit or loss and financial position of an entity. Therefore, the users of the financial statements of any entity should have the knowledge of:

- Related party relationships of an entity.
- Entity's transactions, outstanding balances, commitments etc. with such related parties.

1. DEFINITIONS

The following definitions are relevant for understanding the Standard:

1. A **related party** can be
   - a person or
   - entity that is related to the reporting entity.
2. **Relatives in relation to any person** includes: children, spouse, brother, sister, father and mother

3. **Key management personnel** are those people who have authority and responsibility for planning, directing and controlling the activities of the entity, directly or indirectly, including any director (whether executive or otherwise) of that entity.

   Note:

   The definition includes executive as well as non-executive directors who have responsibility for the management and direction of a significant part of the business. It is not necessary that these people should have the 'director' designation. The term also includes members of the management committee(s), if those committee(s) has the authority for planning, directing and controlling the entity's activities.

Types of Related Party Relationships:

Type 1: Reporting Entity and a Person

Type 2: Reporting Entity and Another Entity

2. TYPE 1 – RELATIONSHIP WITH A PERSON

A **person** or **his relative is related to a reporting entity** if that person:

(a) Has control or joint control over the reporting entity.

(b) Has significant influence over the reporting entity; or

(c) Is a member of the key management personnel (KMP) of the reporting entity

Examples 1:

1. Mr. A holds 51% of the equity share capital of A Limited. A Limited has no other form of share capital. Since Mr. A control A Limited, he is a related party.
2. Mrs. A is wife of Mr. A. Mr. A hold 51% of equity shares of A Limited. A Limited has no other form of share capital. Mr. A controls A Limited. Since Mr. A is a related party, Mrs. A is also a related party of A Limited.
3. Mr. D is a director of A Limited. Being a member of key management personnel of A Limited, he is related to A Limited.

3. TYPE 2 –RELATIONSHIP WITH ANOTHER ENTITY

Following are the related party relationships:

(a) Parent Company and all subsidiary companies of that Parent are related to each other.

Note: Fellow subsidiary companies are also related to each other.

Example 2:

SA Limited and SB Limited are subsidiaries of H Limited. SA Limited, SB Limited and H Limited are related to each other.

(b) Associate or JV of Parent company or any of its subsidiary companies are related to the parent and all subsidiary companies.

Note:

i. Subsidiary companies of the above Associate or JV are also related to Parent and all its subsidiaries.

ii. But Associate/JV of above Associate or JV is not Related Party of the Parent and all its subsidiaries.

Example 3:

AS Limited is an associate of S Limited. S Limited is a subsidiary of H Limited. SH Limited is another subsidiary of H Limited. AS Limited and SH Limited are related parties.

Example 4:
Parent Ltd. has a joint venture in J Ltd. with co-venturer X Ltd. and Parent Ltd. has 35% investment (significant influence) in A Ltd.
Here, Parent Ltd. and J Ltd. are related to each other.
Parent Ltd. and A Ltd. are related to each other.
But Parent Ltd. and X Ltd. (Co-Venturers) are not related to each other.

Example 5:
X Ltd. has Subsidiaries Y Ltd., Z Ltd., A Ltd. & B Ltd.
Also, B Ltd. has an Associate co. C Ltd. and A Ltd. has an associate co. D Ltd.
Here, Group consist of X, Y, Z, A & B only. Entire group is related party of each other.
C Ltd. is related party of all members of group i.e. X, Y, Z, A & B.
D Ltd. is related party of all members of group i.e. X, Y, Z, A & B.
But C Ltd. and D Ltd. are co-associate and are not related party to each other.

Example 6:
R Limited has an associate B Limited. B Limited has a subsidiary S Limited, a joint venture J Limited and an associate A Limited. R Limited is the reporting entity. It identifies B Limited and S Limited as its related parties. J Limited and A Limited are not related parties of R Limited.

(c) If a Person (including his relative) or an Entity is having Control/Significant Influence/KMP over one entity and Control or Significant influence or is a KMP of another entity then both entities are related to each other.

Example 7:
Mr. A controls A Limited (the reporting entity). He also controls B Limited. A Limited and B Limited are related to each other.

Example 8:
Mr. A controls A Limited (the reporting entity). He is a non-executive director of B Limited. A Limited and B Limited are related parties.

Example 9:
Mr. A is Director of A Limited (the reporting entity). He is a non-executive director of B Limited also. A Limited and B Limited are related parties.

4. NO RELATED PARTY RELASHIOSHIPS

(a) Co-venturers of the same Joint Venture are not related to each other.

(b) Major Customers, Finance Providers, Trade unions, Govt. Departments or agencies, Major Supplier, Franchisor, distributor, Agent etc only because of their business dealings with entity.

Example 10:
A Bank and B Bank have provided finance to XY Limited. By virtue of the loan agreement, they occupy a non-executive observer seat on the Board of Directors of XY Limited. A Bank and B Bank are not related parties of XY Limited.

5. RELATED PARTY DISCLOSURES

The disclosure requirements can be broadly classified into two categories.

(a) **Category 1:** Relationship between Parent & Subsidiary, following disclosures are required even when there are not transactions between them during the year:

1) Name of Parent or Subsidiary companies.

2) Name of Ultimate Parent Company (if immediate parent is also a subsidiary)

(b) **Category 2:** Any other Relationship between Entity and a Person or Another entity requires disclosures of relationships and items only when there are related party transactions during the year:

1) Nature of Related Party Relationship

2) Nature and Amount of Transaction during relationship period

3) Outstanding Balance due from or due to as on balance sheet date

4) Expenses recognised in respect of bad-debts due from related parties

5) Provisions created on outstanding balances from related parties

Note: Remuneration paid to key management personnel should be considered as a related party transaction requiring disclosures. In case non-executive directors on the Board of Directors are not related parties, remuneration paid to them should not be considered a related party transaction.

6. OTHER IMPORTANT POINTS

1) A related party transaction can be transfer of resources, services or obligations between reporting entity and related entities, such as:
   - purchases or sales of goods (finished or unfinished);
   - purchases or sales of property and other assets;
   - rendering or receiving of services;
   - leases;
   - transfers of research and development;
   - transfers under licence agreements;
   - transfers under finance arrangements (including loans and equity contributions in cash or in kind);
   - provision of guarantees or collateral;

2) A reporting entity is also exempt from the disclosure requirements in relation to (i) related party transactions (ii) outstanding balances and (iii) commitments with a government or state controlled entity that has control, joint control or significant influence over the reporting entity;

7. (MCQ's from ICAI Material)

1. According to AS-18 Related Party Disclosures, which ONE of the following is not a related party of Skyline Limited?
   (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

2. 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.

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

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

4. 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.
   (a) True
   (b) False

5. 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.
   (a) True
   (b) False

ANSWERS	1	2	3	4	5
	b	d	c	b	b

19 ACCOUNTING STANDARD – 20 EARNINGS PER SHARE

"The beautiful thing about learning is that no one can take it away from you."

1. MEASUREMENT OF BASIC EARNINGS PER SHARE

Earnings Per Share are of two types:

1) Basic EPS (BEPS)
2) Diluted EPS (DEPS)

Basic EPS is calculated as under:

$$\frac{\text{Profit/Loss attributed to Equity Shareholders}}{\text{Weighted Average Number of Equity Shares}}$$

Numerator for EPS – Profit/loss attributable to Equity Shareholders

Particulars	Amount	Remarks
Earnings Before Interest and Tax (EBIT)	XXX	
(-) Interest on Borrowings	(XX)	Actual Interest Rate given in Question
Earnings Before Tax (EBT)	XXX	
(-) Tax Expense	(XX)	CT +/- DT
Earnings After Tax (EAT/PAT)	XXX	
(-) Preference Dividend	(XX)	Assume Cumulative Preference Shares
Profit/Loss attributable to Ordinary ESH	XXX	

Important Points for Numerator:

Preference Dividend	• If Cumulative Preference Shares, then deduct the dividend always • If Non-cumulative Preference Shares, then deduct the dividend only when declared. • Always assume cumulative if not specified in questions

Denominator for EPS – Weighted Average Outstanding Ordinary Shares

Number of Ordinary Shares are considered for Basic EPS adjusted by Time Factor (i.e. No. of days/months for which shares were outstanding during the year as against total days/months during the year)

Calculation of Weighted Avg. Ordinary Shares:

Particulars	W.Avg. No.	Remarks
No. of shares in the beginning of year	XX	
(+) No. of shares issued during the year against cash consideration (Normal issue)	XX	No. of days/months from issued date to year end ÷ 365 days or 12 months
(-) No. of shares buyback during the year	XX	No. of days/months from BB date to year end ÷ 365 days or 12 months
(+) No. of Bonus shares issued during the year	XX	12/12 always

Deciding the date for issue of shares

Sr. No	Nature of transaction	Effective Date when
1	General Rule	From date of consideration receivable or date of issue
2	Exchange for cash	From date of consideration receivable or date of issue
4	Conversion of debt instrument	Date of Accrual of interest is stopped
5	In lieu of interest / principal	Date of Accrual of interest is stopped
6	Exchange of liability	Settlement Date
7	Consideration for acquisition of asset	Asset is recognised in books
8	Rendering of services	When Services are rendered
9	Amalgamation of Companies	Acquisition date (Date of Acquisition of control)
10	Bonus Issue	From Beginning of Previous Year

Special Cases for denominator (Weighted Average outstanding ordinary shares):

Bonus; Share Split; and Share Consolidation	• These shares are issued without any consideration to existing shareholders by capitalization of reserves. • Such reserves are already available since beginning of previous year hence time factor should always be considered from beginning of PY. • PY EPS shall also be restated (calculated again) for CY disclosure purpose by including Bonus shares in PY denominator.
Partly Paid-up Shares	• First, check whether partly paid-up shares are entitled to dividend or not. • If partly paid-up shares are not entitled to a dividend unless they become fully paid up, then do not consider them in BEPS working. They are treated as potential equity shares for DEPS working. • If partly paid-up shares are entitled to a dividend, then calculate weighted average outstanding equity share capital (in ₹) instead of No. as under: No. of Fully Paid-up shares **X** Face Value **X** Time Factor No. of Partly Paid-up shares **X** Paid up Price **X** Time Factor **Total Weighted Avg. Equity Share Capital (in ₹)**

	Calculate Earnings Per Rupee (EPR): Profit/Loss attributable to ESH ÷ Total Weighted Avg. ESC **Calculate EPS as under:** EPR (in ₹) **X** Paid-up price or Face Value
Right Issue (RI)	Right issue of shares has bonus element hence follow the below steps: **Step 1:** Calculate Theoretical Ex right price per share if not available $Formula = \frac{[Fair\ Value\ (before\ right)\ x\ No.of\ share\ (pre-right)]\ +\ Right\ issue\ proceeds}{Total\ shares\ post\ right}$ **Step 2:** Calculate Right Factor (RF) = $\frac{Cum\ Right\ Price}{Ex\ Right\ Price}$ (Cum right price also know as Market price will be given in question) **Step 3:** Weighted Average O/s Ordinary shares of current year: - No. of shares o/s (pre-right) **x** RF **x** No. of Months till the date of RI ÷ 12 (+) No. of shares o/s (post-right) **x** No. of Months after RI till end of year ÷ 12 **Total weighted Avg. O/s ordinary shares** **Step 4:** Calculate BEPS of CY as usual **Step 5:** Calculate Restated BEPS of PY also by considering above RF in weighted avg. calculation of PY

2. DILUTED EARNINGS PER SHARE

1. Diluted EPS is calculated when there are outstanding potential equity shares.

2. Potential Equity Shares are those securities which can be converted into ordinary equity shares in future.
   E.g. Convertible Preference Shares, Convertible Debentures, share warrants, ESOPs, Call Options, partly paid-up shares if not eligible for dividend unless they become fully paid-up, Contingently issuable shares

3. Diluted EPS means reduction of Basis EPS if same earnings will continue with additional no. of shares when potential equity shares will be converted into ordinary shares.

4. Conversion into Ordinary shares may increase the Numerator and Denominator as under:

Numerator	Denominator
Saving of Interest after Tax due to conversion of Debentures.	Increase in No. of Shares due to conversion of Preference shares,

Saving of Preference Dividend due to conversion of Debentures.	Debentures, Warrants, ESOPs and Call Options.

5. Above Change in Numerator and Denominator may increase or decrease the existing Basic EPS.
   If there is a Decrease in EPS = It is Diluted EPS
   If there is a Increase in EPS = It is Anti Diluted EPS

6. Anti diluted EPS is not required to be reported. In that case, DEPS = BEPS

7. DEPS formulae:

Numerator	Denominator
Profit/loss attributable to ESH (+) Savings due to Conversion of Potential Equity Shares (after Tax if required)	Weighted Avg. O/s Ordinary Shares (+) Weighted Avg. O/s Potential Eq. Shares

(Refer Examples 14 onwards)

Special Cases of DEPS:

ESOPs	Earnings (Numerator) = Zero i.e. no adjustment No. of Potential Eq. Shares (Denominator) = Total Options (-) $\frac{\text{Total options x Exercise Price}}{\text{Market Price}}$ Time weight shall be from date of option granted to date of exercise

Example: (ESOP)

If company grants 100 ESOPs to its employee to be exercised at Rs 45 each after 31st March 20X1. The market value of the shares on 15th April 20X1 is Rs 50 each. In Such case, company will get Rs. 4,500 funds from issue of ESOP to employee. But the same shares could have been issued to general public at Rs. 50 each i.e. 4500 ÷ 50 = 90 Shares could have been issued to raise same amount of Rs. 4500 from general public.

It means company will issue 10 shares at free of cost to employee under ESOP. These 10 Shares will be treated as Potential Equity Shares of Dilutive Nature.

3. PRESENTATION OF EPS

1) The Entity shall present BEPS and DEPS in the face of a Statement of Profit and Loss.
2) EPS in case of SFS and CFS:

Sr. No.	Type of Financial statements	Consolidated EPS	Separate EPS
1	Consolidated	Must disclose	Don't disclose
2	Separate	Don't disclose	Must disclose

3) **Net Loss in Continuing Operation:**
DEPS from continuing operation shall be calculated without considering Potential Equity Shares otherwise it gets anti-diluted.

4. PRACTICAL EXAMPLES

EXAMPLE 1:

EBIT = 49,80,000 (Current Year = 23-24)
Current Tax = 12,45,000
DTL = 2,15,000
85% Debenture issued on 1/7/23, ₹75 lacs
9% Non-Cumulative Preference Shares Capital are Outstanding ₹ 40 lacs From Beginning
10% Preference Shares Capital are issued on 1/3/24, ₹ 80 lacs
Preference Dividend not yet Declared
Calculate EAESH

SOLUTION:

Earnings Before Interest & Tax	49,80,000
(-) Interest	(4,78,125)
Earning Before Tax	45,01,875
(-) Tax Expenses	(14,60,000)
Earnings After Tax	30,41,875
(-) Preference Dividend on Cumulative Shares only (since dividend is not declared hence Dividend on Non-Cumulative Pref. Share is ignore)	(66,667)
Earnings Available for Equity Share Holder	**29,75,208**

EXAMPLES 2:

Current Year 23-24
1/4/23: - 10,00,000 Shares are Outstanding
1/7/23: - New issue 60,000 No.
Calculate Weighted Average.

SOLUTION

Alternative 1:

1/4/23	10,00,000 x 12/12	10,00,000
1/7/23	60,000 x 9/12	45,000
		10,45,000

Alternative 2:

1/4/23	Outstanding 10,00,000 x 3/12	2,50,000
1/7/23	Cumulative Outstanding 10,60,000 x 9/12	7,95,000)
		10,45,000

EXAMPLE 3:

Current Year 23-24

1/4/23	10,00,000 Shares are Outstanding
1/7/23	New issue 60,000 no.
1/11/23	Buy Back 25000 no.

SOLUTION

Alternative: 1

	1/4	10,00,000 x 12/12	10,00,000
New Issue	1/7	60,000 x 9/12	45,000
Buy Back	1/11	25,000 x 5/12	(10,417)
			10,34,583

Alternative: 2

10,00,000 x 3/12	2,50,000
+ 10,60,000 x 4/12	3,53,333
+ 10,35,000 x 5/12	4,31,250
	10,34,583

EXAMPLE 4:

EBIT = 32,50,000, Tax Rate = 30%

Current Year = 23-24

As on 1/4/23	Outstanding of Equity Shares = 10,00,000 no.
On 1/4/23	Outstanding 9% Convertible Debenture = ₹ 26,00,000, Face Value = 100/-
On 1/9/23	Convertible Debentures Converted into Equity Shares in the Ratio of 3:1

Calculate EPS

SOLUTION

Working Note 1:

Earnings Before Interest & Tax	32,50,000
(-) Interest (5 months)	(97,500)

Earning Before Tax	31,52,5000
(-) Tax Expenditure @30%	(9,45,750)
Earning After Tax	22,06,750
(-) Preference Dividend	0
Earnings Available for Equity Share Holders	**22,06,750**

Working Note 2:

1/4/23	Outstanding Equity	10,00,000 x 12/12	10,00,000
1/9/23	Conversion 26000x3	78,000 x 7/12	45,5000
			10,45,500

EPS = EAESH/ Weighted average Outstanding no. = 22,06,750/10,45,500 =2.11/-

EXAMPLE 5:

EBIT – 25,00,000, Tax Rate – 30%

As on 1/4	(a) Outstanding Equity = 90,000 No. (b) 9% Debentures of ₹ 60,00,000
On 1/7	Public Issue made of 30,000 No. of Equity Shares
On 1/10	Issued 11% Cumulative Preference Share Capital of ₹ 40,00,000 (Dividend not Declared)
On 1/12	Buyback of 20,000 Equity No.

Calculate BEPS.

Solution:

Working Note 1:

Earnings Before Interest & Tax	25,00,000
(-) Interest	(5,40,000)
Earning Before Tax	19,60,000
(-) Tax Expenditure	(5,88,000)
Earning After Tax	13,72,000
(-) Preference Dividend (6 Months)	(2,20,000)
Earnings Available for Equity Share Holders	**11,52,000**

Working Note 2:

Calculation of Weighted Average Outstanding Equity Share Capital (in ₹)

Date	Particulars	Working	Weighted Avg. Amount
¼	Opening Balance	90,000 x 12/12	90,000
1/7	Public Issue	30,000 x 9/12	22,500
1/12	Buyback	(20,000 x 4/12)	(6,667)
Weighted Average Outstanding Share Capital			**1,05,833**

Basic EPS = 11,52,000/1,05,833 = 10.89/- per Share.

EXAMPLE 6: (Negetive EPS)

EBIT = 8,00,000

Tax Rate = 30%

1/4 = Outstanding 10% Debenture of ₹ 1 Crore

1/4 = Outstanding No. of Equity shares 1,00,000 no.

Calculate EPS

SOLUTION

EPS can be negative also if there is a Loss to the Company

Earnings Before Interest & Tax	8,00,000
(-) Interest	(10,00,000)
Earnings Before Tax	(2,00,000)
(-) Tax	0
Earnings After Tax / Earnings Available for Share Holders	(2,00,000)

EPS (Loss per Share) = (2,00,000)/1,00,000 = -2

EXAMPLE 7 (Bonus):

Previous Year EAESH = 12,00,000

Current Year EAESH = 15,00,000

Current Year Outstanding no. in Beginning = 2,00,000 no.

Current Year Bonus issue in 1/7 = 50,000 no.

Current Year Public Issue in 1/9 = 30,000 no.

Current Year Buy Back in 1/11 = 10,000 no.

Calculate EPS of Current Year & Restated Eps of Previous year.

SOLUTION

Working Note 1: Calculation of weighted Average Outstanding no.

1/4	2,00,000 x 12/12	2,00,000
+ 1/7 Bonus	50,000 x 12/12	50,000
+ 1/9 Public issue	30,000 x 7/12	17,500
- 1/11 Buy Back	(10,000 x 5/12)	(4,167)
		2,63,333

Current Year Eps = 15,00,000/2,63,333 = 5.696/-

Restated Eps of Previous Year = 12,00,000/2,00,000+50,000 = 4.8/-

Example 8 (Share Split):

EAESH PY = 10,00,000

EAESH CY = 15,00,000

Outstanding Equity Since Beginning = 1,00,000 No. of 100/- each

On 1st Nov of CY above 1,00,000 No. of 100/- each converted into 10/- each

Solution:

Once the shares are Split or Consolidated, the new numbers after Split or Consolidation shall be taken into Consideration while Calculating EPS

EPS (CY) = 15,00,000/1,00,0000x12/12 = 1.5/- per share

Profit & Loss A/c

	CY	PY
Net Profit	15,00,0000	10,00,000
	1.5/-	**10/-**

As we can see from above P&L, that CY EPS and PY EPS are not Comparable because of Share Split in CY.

Therefore, we should recalculate the PY EPS based on Share Split as under.

Restated EPS (PY) = 10,00,000/10,00,000 = 1/-

EXAMPLE 9 (Share Consolidation):

EAESH CY = 45,00,000

EAESH PY = 35,00,000

1,00,000 No. of Shares of 10/- each

During CY 10/- Shares Converted into 50/- Shares

Solution:

PY EPS (Actual) = 35,00,000/1,00,000 = 35/-

CY EPS (Actual) = 45,00,000/20,000 = 225/-

PY EPS (Restated) = 35,00,000/20,000 = 175/-

EXAMPLE 10: Partly Paid Shares

(Current Year 23-24)

EAESH = 15,00,000

1/4/23 = 50,000 no. Outstanding equity of ₹ 10 each

1/7/23 = 30,000 no. issued 10/- each, 5/- Paid Up

Calculate BEPS

SOLUTION

1/4	50,000 x 10	5,00,000x12/12	5,00,000
+ 1/7	30,000 x5	1,50,000x9/12	1,12,500
	Weighted Average amount of Share Capital.		**6,12,500**

Earning Per Rupee = 15,00,000/6,12,500 = 2.4489/- (or) 2.45/- per Rupee

Eps for 10/- Fully Paid = 2.4489 x 10/- = 24.489

Eps For 5/- Paid up = 2.4489 x 5/- = 12.2445.

EXAMPLE 11 - Partly Paid Shares:

As on 1/4/23	Opening Outstanding Equity Shares 50,000 of 10/- each, 6/- Paid-up.
On 1/9/23	Public Issue of 30,000 shares made at 10/- each, 7/- Paid up

On 1/10/23	Amount Called @4/- on Opening but Shareholders holding 48,000 Shares have paid.
On 1/12/23	Amount Called @3/- on public issue, all Share Holders have paid.

Note: Partly paid shares are also entitled for Dividend

Calculate Weighted Average Outstanding Equity Shares.

Solution:

Calculation of Weighted Average Outstanding Share Capital (in ₹)

Date	Particulars	Working	Weighted Avg. Amount
1/4/23	Opening Balance	50,000 x 6 x 12/12	3,00,000
1/9/23	Public issue	30,000 x 7 x 6/12	1,22,500
1/10/23	Called @4/-	4,80,000 x 4 x 6/12	96,000
1/12/23	Called @3/-	30,000 x 3 x 4/12	30,000
Weighted Average Outstanding Share Capital			5,48,500
Weighted Avg Outstanding No. of Shares (5,48,500/10)			**54,850 No.**

EXAMPLE 12:

EAESH = 18,00,000

As on 1/4/23	Opening Outstanding 1,00,000 no. of Equity Shares of 10/- each
On 1/7/23	Issued 80,000 No. at 15/- each
On 1/11/23	Issued 50,000 No. at 20/- each

Calculate Weighted Average No. of Equity Shares & BEPS

Solution:

Calculation of Weighted Average Outstanding Share Capital (in ₹)

Date	Particulars	Working	Weighted Avg. Amount
1/4/23	Opening Balance	1,00,000 x 10 x 12/12	10,00,000
1/7/23	Issue	80,000 x 15 x 9/12	9,00,000
1/11/23	Issue	50,000 x 20 x 5/12	4,16,667
Weighted Average Outstanding Equity Share Capital			₹ 23,16,667

Earning Per Rupee = 18,00,000/23,16,667 = 0.777 per Rupee

EPS @10/-	10 x 0.777	7.77/-
EPS @15/-	15 x 0.777	11.65/-
EPS @20/-	20 x 0.777	15.54/-

EXAMPLE 13 (Right Issue)

EAESH = 21,00,000

As on 1/4	Outstanding Shares are 1,50,000 No.
On 1/7	Public Issue of 30,000 No.
On 1/10	Right issue @90/- at ratio of 1:2

On 1/1	Public issue of 50,000 No.

Cum-Right Price = 100/-

Solution:

Step 1:

Ex-Right Price = (1,50,000+30,000) x 100 + (90,000 x 90) / 2,70,000 = 96.67/-

Step 2:

Right Factor = Cum-Right Price / Ex-Right Price = 100/96.67

Step 3:

Weighted Average: - Apply Right Factor only on No. of Shares Outstanding before Right Issue

Date	Working	Weighted Avg. Amount
1/4	1,50,000 x 3/12 x 100/96.67	38,792
1/7	1,80,000 x 3/12 x 100/96.67	46,550
1/10	2,70,000 x 3/12	67,500
1/1	3,20,000 x 3/12	80,000
		2,32,842

BEPS = 21,00,000/2,32,842 = 9.02/- per Share.

EXAMPLE 14:

EBIT = 9,00,000 (Current Year 23-24)

Tax Rate = 30%

1/4/23 = Outstanding 8% Convertible Debenture of ₹ 15,00,000, Face Value is ₹ 100

(Convertible in next year into 50,000 no of equity shares)

1/4/23 = Outstanding equity shares 1,00,000 no.

Calculate BEPS & DEPS

SOLUTION

EBIT	9,00,000
(-) Interest	1,20,000
EBT	7,80,000
(-) Tax 30%	2,34,000
EAESH	**5,46,000**

Basic EPS = 5,46,000/1,00,000

= 5.46/-

DEPS = EAESH + (Saving in Interest net of Tax) **/** Weighted Avg no. of Equity + Weighted Avg Potential No. of Equity

[5,46,000 + (1,20,000 – 30%)] / [(1,00,000 x 12/12) + (50,000 x 12/12)] = 4.20/-

EXAMPLE 15:

Same as Example 19 But instead of Debenture there are Convertible Preference Shares

SOLUTION

(1) BEPS

EBIT	9,00,000
(-) Interest	0
EBT	9,00,000
(-) Tax @ 30%	2,70,000
EAT	6,30,000
(-) Preference Dividend	(1,20,000)
EAESH	5,10,000

BEPS = 5,10,000/1,00,000 = 5.10/-

(2) DEPS =

5,10,000 + Savings in Dividend / Weighted Avg No. of Equity + Weighted Avg No. of Potential Equity

5,10,000 + 1,20,000/1,50,000 = 4.20/-

EXAMPLE 16:

Current Year 23-24

EBIT = 25,00,000

As on 1/4/23	Outstanding 10% Non-Convertible PSC of ₹20 lakhs (Dividend Declared)
On 1/4/23	Outstanding 1,50,000 no. of equity, Tax @30%
On 1/7/23	Issued 18,000 no. of 9% Debentures (face value 100/-) convertible after 3 years in the ratio of 3:1

SOLUTION

EBIT	25,00,000
Interest	1,21,500
EBT	23,78,500
Tax 30%	7,13,550
EAT	16,64,950
Preference Dividend	(20,00,000)
EAESH	14,64,950

BEPS = 14,64,950/1,50,000 = 9.77/-

Calculation of DEPS:

1. Identify potential equity shares outstanding in current year
   Convertible Debenture 9% WEF 1/7/23
   18,000 x 3 = 54,000
2. Weighted average equity Outstanding;
   54,000 x 9/12 = 40,500 no.
3. DEPS: EAESH + saving in Interest of Tax/ weighted Average equity + Weighted Avg. Potential equity

= 14,64,950 + (1,21,500 x 70%)/15,000+40,500

= 8.136/- Per share

EXAMPLE 17:

Same as Example 21, but Conversion Ratio is 1:5

Calculate DEPS

SOLUTION

Weighted Average = 18,000/5 x 1

= 3600

3600 x 9/12 = 2700

DEPS = 14,64,950 + 1,50,000 + 2700

= 10.15/- Anti Diluted

As per AS 20, Anti Diluted EPS need not be disclosed, In such case DEPS shall be disclosed at an amount equal to BEPS. Therefore, Disclosed DEPS = 9.77/-

EXAMPLE 18:

EAESH = 18,00,000

No. of Equity Shares = 1,00,000

During the year, 10,000 no. of Debenture @ 11% Interest issued at face value 100/-

Conversion into equity is 40,000 no. after 3 years

Interest paid on such Debenture = 27,500/-

SOLUTION

Debenture must have been issued on 1/Jan/24

Since Interest of 27,500 belongs to 3 months

Interest	Months
1,10,000	12
27,500	?

DEPS = 18,00,000 + (27,500 x 70%)/1,00,000 + (40,000 x 3/12)

= 16.53/-

EXAMPLE 19:

EAESH = 15,00,000

No. of Outstanding Equity = 1,00,000

BEPS = 15/-

There are 60,000 option (ESOPs) are Outstanding For Full year given to employees at exercise price of 50/- each MP Per shares is 100/- each

Calculate How many Option are dilutive Potential Shares & also Calculate DEPS

SOLUTION

Total ESOP = 60,000 no. Outstanding

1. Dilutive Potential
2. Non-Dilutive (B/F) 30,000

Total ESOP – fund raised/MP

60,000 – 30,00,000/100 = 30,000 (Dilutive potential equity)

DEPS = EAESH + Saving/ Weighted Average equity + Weighted Potential equity

= 15,00,000 + 0* / 1,00,000 + 30,000 x 12/12

= 11.538/-

(* why 0? In ESOP there is no Interest or Dividend Payable)

EXAMPLE 20:

EAESH = 15,00,000

Including extra ordinary Income of 1,50,000

Opening no. of Ordinary equity = 1,00,000

On 1/8 = 10,000 no of shares warrant issued & converted into shares on 1st Jan of Current year

Calculate BEPS & DEPS

SOLUTION

1 **Basic Earnings Per Share**

1/4	1/Jan	31/3
Opening Outstanding 1,00,000	Shares 10,000	

Weighted Average: -

1,00,000 x 12/12	1,00,000
+ 10,000 x 3/12	2,500
	1,02,500

BEPS = EAESH (Including Extra ordinary)/Weighted Average Outstanding equity

= 15,00,000/1,02,500

= 14.634/-

2 **Diluted Earnings Per Share**

1/4	1/8	1/Jan	31/3
Opening Outstanding 10,00,000	Share warrant 10,000	Share 10,000	

Weighted Average Potential Equity = 10,000 x 5/12 = 4167

DEPS = (15,00,000 – 1,50,000) + 0 / 1,02,500 + 4167

= 12.656/-

5. (MCQ's from ICAI Material)

1. AB Company Ltd. had 1,00,000 shares of common stock outstanding on January. 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
   - (a) 1,40,000 shares
   - (b) 1,25,000 shares
   - (c) 1,16,667 shares
   - (d) 1,20,000 shares

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

3. As per AS 20, equity shares which are issuable upon the satisfaction of certain conditions resulting from contractual arrangements are
   - (a) Dilutive potential equity shares
   - (b) Contingently issuable shares
   - (c) Contractual issued shares
   - (d) Potential equity shares

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

5. Partly paid up equity shares are:
   - (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.

ANSWERS	1	2	3	4	5
	c	a	b	b	c

CA NOTES COMMUNITY NETWORK

Click on Icon	QR CODE	LINK
Join what's App group		CLICK HERE
Join Telegram Channel		CLICK HERE
Subscribe On Youtube		CLICK HERE
Follow us On Instagram		CLICK HERE

BE A PART OF CNC FAMILY

CNC – CA NOTES COMMUNITY

Mail at (for complaints/feedback) – canotescommunity@gmai.com

20 ACCOUNTING STANDARD – 22
ACCOUNTING FOR TAXES ON INCOME

"In this world nothing can be said to be certain, except death and taxes".

Let's Understand some important Income Tax Sections first along with their treatment in Books of Accounts: -

1) **Sec-32:** Depreciation deduction as per Tax law is different from Depreciation debit in P&L A/c

2) **Sec-35AD:** 100% deduction of specified capital expenditures in the same year:

Books	Income Tax
• Amortise/Depreciate in more than 1 year • Next years Amortised Expenses will be disallowed • Next year Taxable Income will be Increased	100% Deduction in same year

3) **Sec-36:** Provision for bad debts debited in P&L is disallowed under Income Tax:
Income Tax will give us deduction only on actual Bad-debts incurred.
1st Year Provision for Bad-debts 15,000 debited in P&L, but there is no actual Bad-debts, then it is disallowed in Income Tax, Current Year Taxable Income is increased.

4) **Sec-37:** Personal Expenditure are always dis-allowed.
1st Year: - Personal Expenses of Director debited in Profit & Loss. But in Income Tax it is disallowed Permanently. Current Year taxable Income will be Higher.

5) **Sec-43B:** Deductions of some specified Expenses only on actual Cash Basis.
1st Year: - Bonus Payable is bebited in P&L, then it will be Disallowed and Current Year Taxable Income will be Increased.
2nd Year: Bonus payable is actually Paid, Now Tax Law will give us deduction. Thus, Taxable Income will be reduced.

6) **Sec-35D:** - Preliminary Expenses incurred & fully debited in P&L, but as per Tax Law, 1/5th Deduction is allowed every Year.

	1st	2nd	3rd	4th	5th
Income before Preliminary Expenses	1,00,000	1,00,000	1,00,000	1,00,000	1,00,000
Preliminary Expenses debited in P&L	(10,000)	-	-	-	-
Accounting Income (PBT)	90,000	1,00,000	1,00,000	1,00,000	1,00,000
TAX Law:					
Disallowed	10,000	-	-	-	-
Allowed 1/5	(2,000)	(2,000)	(2,000)	(2,000)	(2,000)
Taxable Income	98,000	98,000	98,000	98,000	98,000
Timing Difference	8,000	(2,000)	(2,000)	(2,000)	(2,000)

7) **Sec-80G**: Donation to religious trust is never allowed as deduction under Income Tax (Disallowed Permanently).

1. DEFINITIONS

1. **Accounting income** 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.
2. **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.
3. **Current tax** is the amount of Income tax determined to be payable (recoverable) in respect of the taxable income (tax loss) for a period.
4. **Deferred tax** is the tax effect of timing differences.
5. **Timing differences** are the differences between taxable income and accounting income for a period that originate in one period and are capable of reversal in one or more subsequent periods.
6. **Permanent differences** are the differences between taxable income and accounting income for a period that originate in one period and do not reverse subsequently. Permanent differences do not result in deferred tax assets or deferred tax liabilities.
7. **Tax Expense (Tax Saving)** is the aggregate of Current tax and Deferred tax charged or credited to the statement of profit and loss for the period.

Tax Expense = Current Tax Expense + Deferred Tax Expense – DT Income

Examples of Timing Differences	Examples of Permanent Differences
• **Depreciation** as per Companies Act different from Depreciation as per Income Tax (Sec 32 of IT Act) – Resulting DTA or DTL • **Sec 43B** of Income Tax Act (Deductions available on cash basis not on provision basis – Bonus, Interest, PF etc) – resulting DTA • **Preliminary Expenses** deduction allowed in 5 years as per Income Tax, but as per AS 26 fully written off – resulting DTA • **Scientific Research Expenses** or Specified Expenses allowed 100% in the same year however in the Books only part is written off. • **Provision for Doubtful debts** disallowed under IT Act until actual bad debts occur.	• **Personal Expenses** disallowed always, never allowed in the Future. • **Donations** to unspecified trust – Disallowed always.

2. UNABSORBED DEPRECIATION AND CARRY FORWARD OF LOSSES

(a) Unabsorbed depreciation and

(b) Carry forward of Losses

which can be set off against future taxable income are also considered as timing difference and result in deferred tax assets, subject to consideration of prudence.

3. PRUDENCE LIMITS: VIRTUAL CERTAINTY

1) Deferred tax should be recognized for all timing differences, subject to the consideration of prudence in respect of deferred tax assets.
2) Prudence concept is already being followed while creating DTL, but while recognizing DTA, income is recognized in the Profit and Loss.
3) While creating DTA on deductible timing differences, certainty of future Taxable Income should be checked that insures sufficient future Taxable Income so that deductions could be claimed.

4) **Para 15 of AS 22: -** DTA on All Timing Differences except "Unabsorbed Depreciation & C/F Business Loss".
Recognise DTA Subject to Reasonable Certainty of Sufficient Future Taxable Profits Against which deductions will be allowed.

5) **Para 17 of AS 22: -** "DTA on Unabsorbed Depreciation & Business Loss carried forward"
Create DTA Subject to "Virtual Certainty supported by Convincing Evidence" that in future there would be Sufficient Future Taxable Profit against which Deductions of unabsorbed Depreciation and Business Losses will be allowed.

6) Most of times, DTAs are created considering reasonable certainty but there are some items on which DTA can be created by checking "Virtual certainty supported by convincing evidence (VCCE)"

Certainty of Future Taxable Income	
Reasonable	**Virtual**
Based on Past Experience	Near to or more than 90% probability of Earning Income
It is more likely that future taxable income will be available i.e. more than 50% Probability	Surety of sufficient future taxable Income For this level of surety convincing evidence should be available. Then only DTA to be created
Deductible Timing difference for which Reasonable Certainty is to be checked are: 1) Depreciation 2) Provision for Bad Debts 3) Sec 43B (Disallowed item)	Deductible Timing difference for which VCCE is to be checked are: C/f Business Losses, and Unabsorbed Depreciation

4. RE-ASSESSMENT OF "UNRECOGNISED DEFERRED TAX ASSETS"

At each balance sheet date, an enterprise re-assesses un-recognised deferred tax assets. (it can be treated as Change in Accounting Estimates)

5. MEASUREMENT

1) **Current tax** should be measured at the amount expected to be paid to (recovered from) the taxation authorities, using the applicable tax rates and tax laws.

2) **Deferred tax** assets and liabilities should be measured using the tax rates and tax laws that have been enacted or substantively enacted by the balance sheet date.

6. DISCOUNTING

Deferred tax assets and liabilities should not be discounted to their present value.

7. REVIEW OF DEFERRED TAX ASSETS

The carrying amount of deferred tax assets should be reviewed at each balance sheet date.

8. PRESENTATION AND DISCLOSURE

An enterprise should offset assets and liabilities representing tax if the enterprise:
(a) Has a legally enforceable right; and
(b) Intends to settle the asset and the liability on a net basis.

9. APPLICATION OF MAT

(a) Minimum Alternate Tax is different from Current Tax. MAT is calculated on Book Profit which is derived with the help of Section 115JB of Income Tax. Book Profit is different from from Taxable Income.

(b) While calculating Current Tax and Deferred Tax, we shall always use Regular Tax Rate and not the MAT Rate.

(c) While calculating timing differences, we shall compare Accounting Income and Taxable Income (not the Book Profit)

(d) MAT is Payable only when it is more than Current Tax. Although, the excess payment is allowed as Credit in Future Years if in Future Current Tax would be higher.

(e) If MAT is higher than Regular Tax, then Current Tax will be Equal to Regular Tax. In that case the Excess of MAT amount over Current Tax amount shall be recognized separately in the Profit and Loss account as an additional Tax Expense.

(f) Hence Items to be debited in Profit and Loss Statements are:

(i) Current Tax calculated on Taxable Income at Regular Tax Rate.

(ii) Deferred Tax calculated on Timing Difference at Regular Tax Rate.

(iii) Excess of MAT over Current Tax.

10. TAX HOLIDAY

(a) The deferred tax in respect of timing differences which reverse during the tax holiday period is not recognised.

(b) Deferred tax in respect of timing differences which reverse after the tax holiday period is recognised in the year in which the timing differences originate. However, recognition of deferred tax assets is subject to the consideration of prudence as laid down in paragraphs 15 to 18.

(c) For the above purposes, the timing differences which originate first are considered to reverse first. (FIFO)

Important Examples to understand the Entire Tax Accounting

Example 1

Assume Income before Provision for Bad-Debts for 23-24 & 24-25 is 10,00,000 p.a.

In FY 23-24 Provision for Bad-Debts created of ₹ 70,000 & Debited to P&L but disallowed in Income Tax.

In FY 24-25 actual Bad-Debts occur for ₹ 70,000 & allowed in Income Tax.

Show Tax Accounting & P&L Extract for both years. Tax Rate 30%.

Solution:

1) Accounting for Provision and Actual Bad-Debts:

FY 23-24			
Profit & Loss A/c	Dr.	70,000	
To Provision for Bad-Debts A/c			70,000
FY 24-25			
Bad Debts A/c	Dr.	70,000	
To Debtors A/c			70,000
Provision for Bad-Debts A/c	Dr.	70,000	
To Bad-Debts A/c			70,000

2) Calculation of Accounting Income (PBT):

	23-24	24-25
Income Before Provision	10,00,000	10,00,000
(-) Provision for Bad Debts	(70,000)	-
A/c Income (PBT)	**9,30,000**	**10,00,000**

3) Calculation of Taxable income & CT thereon:

	23-24	24-25
PBT (A/c Income)	9,30,000	10,00,000
(+) Disallowed Provision	70,000	-
(-) Bad-Debts Allowed	-	(70,000)
Taxable Income	10,00,000	9,30,000
Current Tax @30%	**3,00,000***	**2,79,000****

FINANCIAL YEAR 23-24			
*(1) CT Expense A/c	Dr.	3,00,000	
To CT Payable A/c			3,00,000
(2) Profit & Loss A/c	Dr.	3,00,000	
To CT Expense A/c			3,00,000
FINANCIAL YEAR 24-25			
**(1) CT Expense A/c	Dr.	2,79,000	
To CT Payable A/c			2,79,000
(2) Profit & Loss A/c	Dr.	2,79,000	
To CT Expense A/c			2,79,000

4) Statement of P&L (Extract)

	23-24	24-25
Profit Before Tax (Accounting Income)	9,30,000	10,00,000
(-) Tax Expense	2,79,000	3,00,000

	23-24	24-25		
CT Expense	3,00,000	2,79,000		
(-) DTA	(21,000)	-		
(+) DTA Reserve	-	21,000		

5) Calculation of Tax Difference & DT

	23-24	24-25
Tax Difference Arise	70,000 (DTA)	-
Tax Difference Reversed	-	70,000 (DTA Reversal)
DT Created @30%	**21,000 (DTA)**	**21,000 (DTA Reversal)**
	DTA Dr. **To P&L**	**P&L Dr.** **To DTA**

Example 2

Following information is of X Ltd.

Sale	20,00,000
Cost of goods sold	11,00,000
Income from other sources (Bank Interest)	1,00,000
Salary	1,00,000
Provision for Legal Damages	40,000
Interest to Bank (Not yet paid)	30,000
Service Tax (Not yet Paid)	50,000

X Ltd purchased during the year one Machine for Scientific Research for Rs. 120000 whose life is 3 years and is 100% tax deductible during the year

X Ltd also made contribution for Scientific Research activity of Rs. 10000 on which 100% deduction is allowed in the same year. Effective Rate of Tax 32.33%.

Prepare Profit and Loss Account.

Solve Here:

Calculation of Deferred Tax

S.No.	Particulars	Timing Difference	Nature	DT Amount
1	Provision for Legal Demages	40,000	DTA	12,932
2	Interest Payable	30,000	DTA	9,699
3	Service Tax Payable	50,000	DTA	16,165
4	Capital Expenditure on Scientific Research	80,000	DTL	25,864
	Net DTA DTA A/c Dr. To P&L A/c			12,932

11. (MCQ's from ICAI Material)

1. As per AS 22 on 'Accounting for Taxes on Income', tax expense is:

(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

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 transition adjustment when the tax rate is 50%?

(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 = ₹ 1,50,000

3. State which of the following 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.

(a) Both are correct.

(b) Only (1) is correct.

(c) Only (2) is correct.

(d) None of the statements are correct.

4. Which of the following statement are incorrect:

(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.

ANSWERS	1	2	3	4
	c	d	a	d

Student Notes:-

21

ACCOUNTING STANDARD – 23 ACCOUNTING FOR INVESTMENTS IN ASSOCIATES IN CONSOLIDATED FINANCIAL STATEMENTS

Be miserable. Or motivate yourself. Whatever has to be done, it's always your choice.

1. NEED OF AS 23

- AS 23 describes the principles and procedures for recognizing Investments in Associates (in which the investor has significant influence, but not a subsidiary or joint venture of investor) in the Consolidated Financial Statements (CFS) of the investor.
- An investor which presents consolidated financial statements should account for investments in associates as per Equity Method in Consolidated Financial Statements accordance with this standard.
- For Standalone Financial Statements, AS 13 shall be applied for Investments.

2. IMPORTANT DEFINITIONS

1) A subsidiary is an enterprise that is controlled by another enterprise (known as the parent).
2) A parent is an enterprise that has one or more subsidiaries.
3) A group is a parent and all its subsidiaries.
4) An associate is an enterprise in which the investor has significant influence, and which is neither a subsidiary nor a joint venture of the investor.
5) Significant influence is the power to participate in the financial and/or operating policy decisions of the investee but not control over those policies.
6) The equity method is a method of accounting whereby the investment is initially recorded at cost, identifying any goodwill/capital reserve arising at the time of acquisition. The carrying amount of the investment is adjusted thereafter for the post acquisition change in the investor's share of net assets of the investee. The consolidated statement of profit and loss reflects the investor's share of the results of the operations of the investee.
7) Equity is the residual interest in the assets of an enterprise after deducting all its liabilities.
8) Consolidated financial statements are the financial statements of a group presented as those of a single enterprise.

Note 1: Presumption of significant influence:

- If an entity holds (directly or indirectly through a subsidiary) **20% or more** of the voting rights of an investee then it is presumed that the entity has significant influence, **unless it can be clearly demonstrated that it is not the case.**
- Conversely, if the entity holds, (directly or indirectly through a subsidiary), less than 20% of the voting power of the investee, it is presumed that the entity does not have significant influence, **unless such influence can be clearly demonstrated.**
- It should be noted that a substantial or majority ownership by another investor does not necessarily preclude an entity from having significant influence.

Note 2:

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

Example 1

A Ltd. has 70% holding in C Ltd. and B Ltd. also has 28% holding in the same company. So, A Ltd., with the majority holding i.e., more than 50% is the parent company i.e., a holding company. Since B Ltd. holds more than 20% but not more than 50% in C Ltd., C Ltd. will be an associate of B Ltd.

Example 2

A Ltd. holds 90% shares in B Ltd. and 10% shares in C Ltd., and B Ltd. is holding 11%shares in C Ltd. In this case, A Ltd. is parent of B Ltd.

As far as the relationship between A Ltd. and C Ltd. is concerned, A Ltd. has a total of direct and indirect holdings of (10 + 11) 21% in C Ltd., Thus, C Ltd. is an associate of A Ltd. It may however be noted that for consolidated financial statement purposes, the holding will be 19.9% (10% + 90% of 11%).

3. EQUITY METHOD

In a Simple Language, Equity means Net Assets. Therefore, Equity Method means Measuring the value of Investments in Proportion to Fair Value of Net Assets of Investee (i.e. Associate Entity).

Value of Investment shall be increased or decreased by-	Rs.	2nd effect to-
Cost of Investments (Including Goodwill)	xxxx	
Add/Less: Post acquisition share in P&L of Associate Co. (EAESH)	xxx	CPL of investor
Less: Distributions received by way of dividend	xxx	CPL of Investor
Less: Additional depreciation on revaluation profit of PPE (if any)	xxx	CPL of Investor
Less: **Un-realised profit** on downstream transaction to the extent of Investor's share in gain/loss of Associate/JV	xxx	CPL of Investor
Value of Investments as per Equity Method	**XXXX**	

Note:

1. **Goodwill:**
   If cost of Investment is greater than investor's share of investees' net assets – it is not separately presented. It is included in the carrying amount of investment.
2. **Capital reserves:**
   If the cost of investment is less than investor's share of investee's net assets – it is recognised directly in Reserves & Surplus in the period in which investment is made.

Journal Entry as on acquisition date:

Investment A/c Dr.
To Capital Reserve A/c

Example 3: -
On 1/4/24, B Ltd. acquired 20% Equity interest in A Ltd. at a cost of 2,40,000/-
Fair Value of Net Assets of A Ltd. on 1/4/24 is 10,00,000/-
Apply Equity Method on DOA.

Solution:

Cost of Investment @ 20%	2,40,000
(-) Proportionate Value of Net Assets @ 20%	2,00,000
Goodwill	**40,000**

SFS of B Ltd. as on 1/4/24 (AS 13)

Investment @ 20%	2,40,000

CFS of B Ltd. as on 1/4/24 (AS 23)

Investment @ 20% (Including Goodwill 40,000)	2,40,000

As per AS 23, Goodwill is not required to be recognized separately, it is just a part of Investment Cost.

Example 4: -

Same as Example 3, But Fair Value of Net Assets on DOA is 15,00,000

Solution:

Cost of Investment @ 20%	2,40,000
(-) Proportionate Value of Net Assets @ 20%	3,00,000
	60,000

Investment are under-valued, We have to record 60,000 to make it @3,00,000

Investment A/c Dr.	60,000	
To Capital Reserve A/c		60,000

CFS of B Ltd. as on 1/4/24 (AS 23)

Reserves & Surplus : CR	60,000
Investment @ 20%	3,00,000

Example 5: -

On 1/4/24, B Ltd acquired 20% Equity Interest in A Ltd. at a cost of 2,40,000/-

On 1/4/24, Equity share Capital of A Ltd. was 8,00,000/- and Reserves & Surplus was 3,00,000

On 31/3/25 Reserves & Surplus of A Ltd was 5,00,000

Apply AS 23 on DOA & Balance Sheet Date.

Solution:

Fair Value of Net Assets = 11,00,000

Hence Proportionate Investments should be = 2,20,000

Therefore, Goodwill = 20,000

Equity Method (AS 23)

Investment Cost as on DOA (Including Goodwill 20,000)	2,40,000
+ 20% Share in Post-Acquisition Profits of Associate (2,00,000 x 20%)	40,000
Investment 31/3	2,80,000

Post Acquisition Profit Earned by Associate = 2,00,000

Share of Investor in Post Acquisition Profit = 40,000

Investor Shall Increase its Value of Investment by 40,000

31/3 Journal Entry

Investment A/c Dr. 40,000
To Consolidated P&L A/c 40,000

Consolidated Balance Sheet of Investor

Reserves & Surplus: Consolidated P&L will be increased by-	40,000
Investment @ 20% (Including Goodwill)	2,80,000

Example 6: -

On 1/4/24 B Ltd. acquired 20% Equity interest in A Ltd. at a cost of 2,40,000/-

On 1/4/24 Equity Share Capital of A Ltd was 8,00,000 and Reserves & Surplus of A Ltd. was 3,00,000

On 31/3/25 Reserves & Surplus of A Ltd. was 5,00,000

During 24-25, Dividend Paid by A Ltd. to its Share Holders 15%

Apply AS 23 on DOA & Balance Sheet Date.

Solution:

Analysis of Profit of A Ltd.

	Capital Profit	**Post – Acquisition**	**Balance Sheet**
Reserves & Surplus	3,00,000	2,00,000	5,00,000
+ Dividend	-	1,20,000	
	3,00,000	**3,20,000**	

- 3,20,000 is the Total Earning of A Ltd. for the year
- Post-Acquisition share in Profit (20%) = 64,000

Equity Method

Investment Cost as on DOA (Including Goodwill 20,000)	2,40,000
(+) 20% share in Post – Acquisition Profit @ 20%	64,000
(-) Dividend Received	(24,000)
Investment @ 20% as per Equity	**2,80,000**

1/4/24 - Investment Purchased

Investment A/c Dr. 2,40,000
To Bank A/c 2,40,000

31/3/25 - Consolidation

Investment A/c Dr. 64,000
To Consolidated P&L 64,000

During 24-25 - Dividend Received

Bank A/c	Dr.	24,000	
To Investment A/c			24,000

(This is not Income. This is Recovery)

4. EXEMPTIONS FROM APPLYING THE EQUITY METHOD

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

a. Significant Influence (Control over Investment) is intended to be temporary because the investment is acquired and held exclusively with a view to its subsequent disposal in the near future.

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

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

5. STEP ACQUISITION IN CASE OF AN ASSOCIATE:

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

Case 1: Conversion from a passive investor to an associate in the same year:

Example 7: A Ltd. acquired 10% stake of B Ltd. on April 01 and further 15% on October 01 during the same year. Other information is as follow:

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

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

Calculations for April 01:

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

Calculations for October 01:

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

Example 8: A Ltd. acquired 10% stake of B Ltd. on April 01 and further 15% on 1st October of the same year. Other information is as follow:

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

Net asset on 1st April ₹ 8,50,000 and on 1st October ₹ 10,00,000.

Calculations for April 01:

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

Calculations for October 01:

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

Case 2: Further acquisition in an associate in the same year:

Example 9: A Ltd. acquired 25% stake of B Ltd. on 1st April and further 5% on 1st October of the same year. Other information is as follow:

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

Net asset on 1st April ₹ 5,00,000.

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

Calculations for April 01:

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

Calculations for October 01:

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

6. MISCELLENEOUS POINTS UNDER AS 23

1. Loss Making Associate Entity:

If, under the equity method, an investor's share of losses of an associate equals or exceeds the carrying amount of the investment, the investor ordinarily discontinues recognising its share of further losses and the investment is reported at nil value. Additional losses are provided for to the extent that the investor has incurred obligations or made payments on behalf of the associate to satisfy obligations of the associate that the investor has guaranteed or to which the investor is otherwise committed. If the associate subsequently reports profits, the investor resumes including its share of those profits only after its share of the profits equals the share of net losses that have not been recognised.

2. Different Reporting Periods:

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

3. Uniform Accounting Policies:

- Accounting policies followed in the preparation of the financial statements of the investor, investee and consolidated financial statement should be uniform for like transactions and other events in similar circumstances.
- If accounting policies followed by different enterprises in the group are not uniform, then adjustments should be made in the items of the individual financial statements to bring it in line with the accounting policy of the consolidated statement.

4. Decline in the Value of Investment:

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

5. Proposed Dividend in Associate Entity:

In case an associate has made a provision for proposed dividend (i.e. dividend declared after the reporting period but it pertains to that reporting year) in its financial statements, the investor's share of the results of operations of the associate should be computed without taking into consideration the proposed dividend.

6. Treatment of Un-realised Profit on Unsold Stock

S.No.	Downstream Transaction (Sale of goods by Investor to Associate)	Upstream Transaction (Sale by Associate to Investor)
1.	Profit is earned by investor	Profit is earned by Associate
2.	Unsold Inventory is lying with Associate	Unsold Inventory is lying with Investor
3.	Investor shall reverse in its own share of profit earned a such Inventory in Consolidated Financial Statement.	Investor shall reverse its own share of profit in Consolidated Financial Statement.
4.	Consolidated Profit and Loss A/c Dr. To Investment A/c (Since Inventory is lying with Associate, hence Investor can-not credit inventory a/c)	Consolidated Profit and Loss A/c Dr. To Inventory A/c (Here Inventory is lying with Investor, hence the same is credited)

Example 10:

B Ltd. (Investor) has 30% Investment in A Ltd. (Associate)

A Ltd. has sold goods costing Rs. 1,00,000 to B Ltd. @Rs. 1,50,000.

All goods are Unsold at year end.

How to eliminate Unrealised Profit?

Solution:

Associate has sold goods to Investor so this is an Upstream Transaction

A Ltd. must have recognised profit on sale of Rs. 50,000 in its P&L.

Therefore, Investor's Share in above Profit is Rs. 15,000 (30% of Rs. 50,000) & through equity method this must have been a part of Investment A/c and P&L A/c of B Ltd.

Investment A/c Dr.	15,000	
To Consolidated P & L A/c		15,000

Now, Investor B Ltd. has unsold Inventory of Rs. 1,50,000 Which includes Rs. 15,000 Profit Shares of Investor (B Ltd.)

Therefore, 15,000 Profit shall be eliminated as under:

Consolidated P & L A/c Dr.	15,000	
To Inventory A/c		15,000

In case of A Ltd. is a Subsidiary:

Consolidated P & L A/c Dr.	12,000	
Minority Interest A/c	3,000	
To Investment A/c		15,000

Example 11:

In Above Example assume B Ltd. (Investor) has Sold goods to A Ltd. (Associate)

Solution:

Downstream Transaction

1) Full 50,000 earned by Investor (B Ltd.) from sale of goods.

2) Unsold Inventory lying at Associate at 1,50,000/-

Since Inventory is a part of Net Assets of Associates, we can conclude that Net Assets of Associate Company includes Un-realised profit of 50,000/-

Equity Method means Proportionate Share of Net Assets of Associates. Therefore, when we will apply equity method, Investment must be shown in Proportion of Net Assets i.e., 30% of Net Assets

Which means Investment Value must include 15,000 Un-realised Profit which is to be eliminated.

Consolidated P&L A/c Dr. 15,000

To Investment A/c 15,000

7. (MCQ's from ICAI Material)

1. Identity which of the statements are correct.

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

   (i) Representation on the board of directors or governing body of the investee.

   (ii) Participation in policy-making processes.

   (iii) Interchange of managerial personnel.

   (iv) Provision of essential technical information.

   (a) Statement (i) and (ii) are correct.

   (b) Statement (i), (ii) and (iii) are correct.

   (c) Statement (i), (ii), (iii) and (iv) are correct.

   (d) Statement (ii) and (iii) are correct.

2. A Ltd. is holding 90% share in B Ltd. and 10% shares in C Ltd., and B Ltd. is holding 11% shares in C Ltd.

   Identity which of the statements are incorrect.

   (i) In this case, A Ltd. is parent of B Ltd.

   (ii) As far as the relationship between A Ltd. and C Ltd. is concerned; A Ltd. has a total of direct and indirect holding of (10% + 90% of 11%) 19.9 % in C Ltd.

   (iii) C Ltd. is an associate of A Ltd.

   (a) Statement (ii) is incorrect.

   (b) Statement (iii) is incorrect.

   (c) Statement (ii) and (iii) both are incorrect.

   (d) All statements are incorrect.

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

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

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

   What is the amount of goodwill or capital reserve arising on significant influence?

   (a) Goodwill = ₹ 10,000.

   (b) Goodwill = ₹ 20,000.

   (c) Capital Reserve = ₹ 10,000.

   (d) Capital Reserve = ₹ 20,000.

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

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

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

   What is the amount of goodwill or capital reserve arising on significant influence?

   (a) Goodwill = ₹ 10,000.

(b) Goodwill = ₹ 20,000.

(c) Capital Reserve = ₹ 10,000.

(d) Capital Reserve = ₹ 20,000.

5. Identity which of the statements are correct.

(i) In case an associate has made a provision for proposed dividend (i.e. dividend declared after the reporting period but it pertains to that reporting year) in its financial statements, the investor's share of the results of operations of the associate should be computed without taking into consideration the proposed dividend.

(ii) In case an associate has made a provision for proposed dividend (i.e. dividend declared after the reporting period but it pertains to that reporting year) in its financial statements, the investor's share of the results of operations of the associate should be computed after taking into consideration the proposed dividend.

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

(iv) The potential equity shares of the investee held by the investor should be taken into account for determining the voting power of the investor.

(a) Statement (i) and (iii).

(b) Statement (ii) and (iv).

(c) Statement (i) only.

(d) Statement (iii) only.

ANSWERS	1	2	3	4	5
	c	a	b	a	a

22 ACCOUNTING STANDARD – 24 DISCONTINUING OPERATION

SUCCESS IS THE SUM OF SMALL EFFORTS,
REPEATED DAY IN AND DAY OUT.

1. INTRODUCTION

Para 3: AS 24 is applicable to all discontinuing operations.

DISCONTINUING OPERATION:

A discontinuing operation is a **component** of an enterprise:

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

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

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

   (iii) Terminating through **abandonment** (giving up completely) and

b. That **represents a separate major line** of business or geographical area of operations. (for example Business Segments or geographical Segments as defined in AS 17)

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

2. DISCONTINUED OPERATION DOES NOT INCLUDE DISCONTINUATION OF A SINGLE PRODUCT ONLY OR DISCONTINUING A BUSINESS IN A PARTICULAR AREA.

To qualify as a discontinuing operation, the disposal must be pursuant to a single coordinated plan. However, changing the scope of an operation or the manner in which it is conducted is not abandonment because that operation, although changed, is continuing.

Examples of Not a Discontinuing Operations:

a. Gradual or evolutionary phasing out of a product line or class of service.
b. Discontinuing, even if relatively abruptly, several products within an ongoing line of business.
c. Shifting of some production or marketing activities for a particular line of business from one location to another and
d. Closing of a facility to achieve productivity improvements or other cost savings.

(V.V.IMP)

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

a. The operating assets and liabilities of the component can be directly attributed to it.
b. Its revenue can be directly attributed to it.
c. At least a majority of its operating expenses can be directly attributed to it.

(Assets, liabilities, Revenues and Expenses can be directly attributable)

The fact that a disposal of a component of an enterprise is classified as a discontinuing operation under AS 24 does not, in itself, bring into question the enterprise's ability to continue as a going concern.

(V.V.IMP)

Initial Disclosure event

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

a. The enterprise has entered into a binding sale agreement for substantially all of the assets attributable to the discontinuing operation or
b. The enterprise's board of directors or similar governing body has both
   (i) approved a detailed, formal plan for the discontinuance and
   (ii) Made an announcement of the plan.

Note:

A detailed, formal plan for the discontinuance normally includes:

- Identification of the major assets to be disposed of;
- The expected method of disposal; (i.e. how we are going to dispose the business or assets)
- The period expected to be required for completion of the disposal;
- The principal locations affected;
- Approximate number of employees who will be compensated for terminating their services; and
- The estimated proceeds or salvage to be realised by disposal.

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

3. PRESENTATION AND DISCLOSURE

1. Initial Disclosure (in the first financial statements subsequent to announcement)

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

a. A description of the discontinuing operation(s)
b. The business or geographical segment(s) in which it is reported as per AS 17
c. The date and nature of the initial disclosure event.
d. The date or period in which the discontinuance is expected to be completed if known or determinable
e. The carrying amounts, as of the balance sheet date, of the total assets to be disposed of and the total liabilities to be settled
f. The amounts of revenue and expenses in respect of the ordinary activities attributable to the discontinuing operation during the current financial reporting period
g. The amount of pre-tax profit or loss from ordinary activities attributable to the discontinuing operation during the current financial reporting period, and the income tax expense related thereto
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

Where to disclose above items?

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

2. Further disclosures (in the next financial statements)

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

when the events occur:

a. For any gain or loss that is recognised on the disposal of assets or settlement of liabilities attributable to the discontinuing operation,
   (i) the amount of the pre-tax gain or loss and
   (ii) income tax expense relating to the gain or loss and
b. The net selling price or range of prices (which is after deducting expected disposal costs) of those net assets for which the enterprise has entered into one or more binding sale agreements, the expected timing of receipt of those cash flows and the carrying amount of those net assets on the balance sheet date.

3. Updating the disclosures

In addition to these disclosures, an enterprise should include, in its financial statements, for periods subsequent to the one in which the initial disclosure event occurs, a description of any significant changes in the amount or timing of cash flows relating to the assets to be disposed or liabilities to be settled and the events causing those changes.

4. TILL WHICH PERIOD THE DISCLOSURES SHOULD BE GIVEN? (IMPORTANT)

The disclosures should continue in financial statements for periods upto and including the period in which the discontinuance is completed.
Discontinuance is completed when the plan is substantially completed or abandoned, though full payments from the buyer(s) may not yet have been received.
If an enterprise abandons or withdraws from a plan that was previously reported as a discontinuing operation, that fact, reasons therefore and its effect should be disclosed.

5. SEPARATE DISCLOSURE FOR EACH DISCONTINUING OPERATION

Any disclosures required by AS 24 should be presented separately for each discontinuing operation.

V.V.IMP

Presentation of the required disclosures

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

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

6. RESTATEMENT OF PRIOR PERIODS

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

7. 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 is 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.

Note: Discontinuing One Operations (component) doesn't always necessary that there is doubt of Going concern on other continuing operation.

Example 1.

Co XY runs a famous chain of restaurants. It decides to sell its stake in one of the restaurant. This restaurant contributes around 5% of total revenue to the entire business. XY does not sell any other restaurant as part of its strategy.

In the above case, the sale of one restaurant out of the chain does not constitute disposal of business under a single plan, or a portion that represents a major line of business or geographical area of operations. Thus, it cannot be regarded as a discontinuing operation.

Example 2

Group MN operates in various industries including Hotels, Airlines and Software through its subsidiaries. It has decided to sell its Airline business to be able to concentrate on other verticals. As a result, it has started to sell its aircrafts and paying off the associated liabilities. During the year, it has sold off 5 aircrafts out of the fleet of 50 aircrafts so far as part of the sale. The Airline business constitutes 25% of total group revenue.

In the above case, Airline business may be considered as **discontinuing operation**. This is due to the fact that the assets are sold off as part of a single plan, and that the business represents a separate major line of business, and can be distinguished both operationally and for financial reporting purposes.

Example 3

Entity RT operates in a single state and is trading in 3 products – X, Y and Z. Details with respect to the performance of each of the products are as under:

Particulars	**X**	**Y**	**Z**	**Total**
Sales	1,00,000	14,00,000	20,00,000	35,00,000
Cost of Goods Sold	(80,000)	(10,80,000)	(14,40,000)	(26,00,000)
Gross Margin	20,000	3,20,000	5,60,000	9,00,000
Operational Expenses	(15,000)	(1,70,000)	(3,60,000)	(5,45,000)
Profit before Tax	5,000	1,50,000	2,00,000	3,55,000

RT has decided to sell the business relating to Product Y to another entity. Since Product Y constitutes a major product, it may be considered as a discontinuing operations.

Example 4

GH, a large car manufacturing company, decides to discontinue its manufacturing operations relating to the diesel cars production. It plans to restructure the business by revamping its existing operations, and starting new manufacturing process for manufacture and sale of electric vehicles.

In the above example, it needs to be evaluated whether the restructuring is a result of continuing operations, or termination of existing operations, and accordingly it can be concluded whether it is a case of discontinuing operations or not.

8. (MCQ's from ICAI Material)

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:
   (a) 1st March 20X1
   (b) 15th March 20X1
   (c) 31st March 20X1
   (d) 31st July 20X1

2. To qualify as a component that can be distinguished operationally and for financial reporting purposes, the condition(s) to be met is (are):
   (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

3. Identify which of the following statements is incorrect?
   (a) A discontinuing operation is a component of an enterprise that represents a 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 or may 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.

4. Identify the incorrect statement.
   (a) Discontinuing operations are infrequent events, but this does not mean that 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 relevant Accounting 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.

ANSWERS	1	2	3	4
	b	d	c	b

CA NOTES COMMUNITY NETWORK

Click on Icon	QR CODE	LINK
Join what's App group		CLICK HERE
Join Telegram Channel		CLICK HERE
Subscribe On Youtube		CLICK HERE
Follow us On Instagram		CLICK HERE

BE A PART OF CNC FAMILY

CNC – CA NOTES COMMUNITY

Mail at (for complaints/feedback) – canotescommunity@gmai.com

23 ACCOUNTING STANDARD – 25
INTERIM FINANICAL REPORTING

Always Remember that your present situation is not your final destination, the Best is yet to come

PURPOSE OF INTERIM FINANCIAL REPORTING

To update the Shareholders and other stakeholders along with timely information.

1. INTERIM PERIOD MEANS:

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

2. INTERIM FINANCIAL REPORT MEANS:

1. Interim financial report means a financial report for less than 1 financial year which contains either a complete set of financial statements or a set of condensed financial statements.
2. Annual Financial Reporting means preparation of financial statements for annual period i.e. 1 year as per Schedule III

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

3. CONTENTS OF AN INTERIM FINANCIAL REPORT – CONDENSED SET:

An Interim Financial Report shall include the following:

- A condensed balance-sheet
- A condensed statement of profit and loss
- A condensed statement of changes in equity
- A condensed statement of cash flows
- Notes, comprising significant accounting policies and other explanatory information

✓ An entity may be required to or may elect to provide less information at interim dates as compared with its annual financial statements.

✓ The interim financial report focuses on new activities, events, and circumstances and does not duplicate information previously reported.

✓ Choice with Entity: Entity has the option to select either to prepare the Complete set of interim financial reporting or to prepare a set of condensed financial report.

✓ Condensed statements should include, at a minimum:
- each of the headings and sub-headings that were included in its most recent annual financial statements;
- the selected explanatory notes as required by this Statement.
- Additional line items or notes should be included if their omission would make the condensed interim financial statements misleading.
- If an enterprise presents basic and diluted earnings per share in its annual financial statements in accordance with AS 20, then it has to present basic and diluted earnings per share as per AS 20 on the face of Statement of Profit and Loss complete for an interim period also.

4. PERIODS FOR WHICH INTERIM FINANCIAL STATEMENTS ARE REQUIRED TO BE PRESENTED:

Example: Suppose entity is preparing Interim Financial Report for the period 1st July 20X2 to 30th September 20X2 i.e. 3 Months, then following should be reported:

	Current Year	Previous Year
Balance Sheet	As at the End of Current Interim Period i.e. 30th Sep 20X2	Comparative BS as at the end of Previous financial year 31st March, 20X1
Statement of Profit and Loss	Current Interim Period 01/07/X2 - 30/09/X2 Year to Date (CY) 01/04/X2 - 30/09/X2	Previous Interim Period 01/07/X1 - 30/09/X1 Year to Date (PY) 01/04/X1 - 30/09/X1
Statement of Cash Flows	Year to Date Only 01/04/X2 - 30/09/X2	Year to Date Only 01/04/X1 - 30/09/X1

5. RECOGNITION AND MEASUREMENT:

Sr. No.	Criteria	Recognition and Measurement
1	Same accounting policies as annual	An entity shall apply the same accounting policies in its interim financial statements as are applied in its annual financial statements, except for accounting policy changes made after the date of the most recent annual financial statements that are to be reflected in the next annual financial statements.
2	Recognition of Incomes and Expenses	Incomes and Expenses shall be fully recognised in the same interim period in which they are earned or incurred. Entity should not defer the expenses to next period or anticipate the expenses early from next period on the assumption of higher or lower sales in those periods. **Note:** Bonus to Employees can be deferred or anticipated. Examples of such items are: Bad-debts, Marketing and promotion, depreciation, employee benefit expenses, interest cost, general and administration overheads etc. Revenues that are received seasonally, cyclically, or occasionally within a financial year shall not be anticipated or deferred. Examples include dividend revenue, royalties, and government grants.
3	Fixed Overheads allocation to Production	**Step 1: Calculate Fixed Overhead rate per unit:** $\frac{\text{Total Fixed Overheads}}{\text{Higher of Normal or Actual Capacity}}$ **Step 2: Allocation of Fixed Overheads** Actual Production Year to Date x Fixed OH rate (Step 1) (-) Absorbed till last interim period **Step 3: Remaining Fixed Overheads** Total Fixed Overheads Less Absorbed overheads are charged to Profit and loss.
4	Tax Expense for Interim Period	Profit/loss of each interim period may contain 2 parts: (a) Normal Business Profit and;

		(b) Special Income (e.g. capital gains) taxable at special rate Tax Expense for Interim Period will be sum of: (a) Normal Profit/loss **X** WATR (b) Special Income **X** Special Rate **Weighted Average Tax Rate (WATR):** $\frac{\text{Estimated Annual Tax Amount}}{\text{Estimated Annual Income}} \times 100$ **Note:** Estimated Annual Tax will be calculated after w/off carried forward losses if given in the question.
5	**Reversal of Impairment Loss**	Except for Goodwill, Impairment loss recognised in earlier interim period can be reversed due to change in conditions.

6. SIGNIFICANT EVENTS AND TRANSACTIONS

The following is a list of events and transactions for which disclosures would be required if they are significant: the list is not exhaustive.

1. The write-down of inventories to Net Realisable value and the reversal of such write down;
2. Recognition of a loss from the impairment of financial assets, property, plant and equipment, intangible assets, or other assets, and the reversal of such an impairment loss
3. Acquisitions and disposals of items of property, plant and equipment.
4. Litigation settlements.
5. Corrections of prior period errors.
6. Any loan default or breach of a loan agreement that has not been rectified on or before the end of the reporting period.
7. Related party transactions.
8. Transfers between levels of the fair value hierarchy used in measuring the fair value of financial instruments.
9. Changes in the classification of financial assets as a result of a change in the purpose or use of those assets; and
10. Changes in contingent liabilities or contingent assets.

7. (MCQ's from ICAI Material)

1. AS 25 mandates the following in relation to interim financial reports.
   (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.

2. The standard defines Interim financial Report as a financial report for an interim period that contains a set of ……… financial statements.
   (a) Complete
   (b) Condensed
   (c) Financial statement similar to annual
   (d) Either complete or condensed

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.
   (a) ₹ 17,000
   (b) ₹ 30,000
   (c) ₹ 2,000
   (d) AS 25 does not mandate to report tax expenses

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?
   (a) ₹1 million
   (b) ₹ 2 million
   (c) ₹ 1.25 million
   (d) ₹ 1.5 million

Answers	1	2	3	4
	d	d	a	b

Student Notes: -

24 ACCOUNTING STANDARD – 27 FINANCIAL REPORTING OF INTERESTS IN JOINT VENTURES

1. WHY AS 27

- There are so many examples in real life where 2 or more entities are working together to achieve a certain purpose. Hindustan Unilever Ltd (HUL), Tata Starbucks Ltd, Tata SIA Airlines Ltd. (Vistara), etc. are a few popular examples of Joint Ventures.
- Depending on the contractual arrangement, the accounting and reporting for Joint Ventures is done and the same is prescribed in AS 27
- This Standard should be applied in accounting for interests in joint ventures and the reporting of joint venture assets, liabilities, income and expenses in the financial statements of venturers and investors, regardless of the structures or forms under which the joint venture activities take place.
- The provisions of this AS need to be referred to for consolidated financial statement only when CFS is prepared and presented by the venturer.

2. IMPORTANT DEFINITIONS

1. **A joint venture** is a contractual arrangement whereby two or more parties undertake an economic activity, which is subject to joint control.
   From the above definition we conclude that the essential conditions for any business relation to qualify as joint venture are:
   a. **Two or more parties coming together:** Parties can be an individual or any form of business organization say, BOI, AOP, Company, firm.
   b. **Venturers undertake some economic activity:** Economic activity means activities with the profit-making motive. Joint venture is separate from the regular identity of the venturers, it may be in the form of independent and separate legal organization other than regular concern of the venturer engaged in the economic activity.
   c. **Venturers have joint control on the economic activity:** The operating and financial decisions are influenced by the venturers and they also share the results of the economic activity.
   d. **There exists a contractual agreement:** The relationship between venturers is governed by the contractual agreement. This agreement can be in the form of written and signed agreement or as minutes of venturer meeting or in any other written form.

2. **Joint control** is the contractually agreed sharing of control over an economic activity.

3. **Control** is the power to govern the financial and operating policies of an economic activity so as to obtain benefits from it.

4. A **venturer** is a party to a joint venture and has joint control over that joint venture.

5. An **investor** in a joint venture is a party to a joint venture and does not have joint control over that joint venture.

6. **Proportionate consolidation Method** is a method of accounting and reporting whereby a venturer's share of each of the assets, liabilities, income and expenses of a jointly controlled entity is reported as separate line items in the venturer's financial statements.

3. CONTRACTUAL ARRANGEMENT

The joint venture covered under this statement is governed on the basis of contractual agreement. Non-existence of contractual agreement will disqualify an organization to be covered in AS 27. Joint ventures with contractual agreement will be excluded from the scope of AS 27 only if the investment qualifies as subsidiary under AS 21, in this case, it will be covered by AS 21. Contractual agreement can be in the form of written contract, minutes of discussion between parties (venturers), articles of the concern or by-laws of the relevant joint venture

The main object of contractual agreement is to distribute the economic control among the venturers, it ensures that no venturer should have unilateral control.

Example 1

IDBI gave loan to the joint venture entity of L&T and Tantia Construction, they signed an agreement according to which IDBI will be informed for all important decisions of the joint venture entity. This agreement is to protect the right of the IDBI, hence just signing the contractual agreement will not make investor a venturer.

Example 2

X Ltd invested ₹ 200 crore as initial capital along with Y Ltd and Z Ltd in GFH Ltd. The purpose of X Ltd making this investment is to grow the business of GFH Ltd along with the other investors. All investors have a right to attend to the meetings and to take decisions with respect to the business of GFH Ltd. All investors are actively involved in running the business of GFH Ltd and have a share in the returns generated by GFH Ltd in an agreed proportion.

GFH Ltd is an example of a Joint Venture and X Ltd, Y Ltd and Z Ltd are all Venturers.

Similarly, just because contractual agreement has assigned the role of a manager to any of the venturer will not disqualify him as venturer.

Example 3

Mr. A, M/s. B & Co. and C Ltd. entered into a joint venture, where according to the agreement, all the policies making decisions on financial and operating activities will be taken in a regular meeting attended by them or their representatives. Implementation and execution of these policies will be the responsibility of Mr. A. Here Mr. A is acting as venturer as well as manager of the concern.

Note:

Any structure which satisfies the following characteristics can be classified as joint ventures:

(a) Two or more venturers are bound by a contractual arrangement and

(b) The contractual arrangement establishes joint control.

4. FROM OF JOINT VENTURES

Joint ventures may take many forms and structures, this Statement identifies them in three broad types –

- **Jointly Controlled Operations (JCO),**
- **Jointly Controlled Assets (JCA) and**
- **Jointly Controlled Entities (JCE).**

4.1 JOINTLY CONTROLLED OPERATIONS (JCO)

Under this set up, venturers **do not create a separate entity** for their joint venture business but they use their own resources for the purpose. They raise any funds required for joint venture on their own, they incur any expenses and sales are also realised individually. They use same set of assets and employees for joint venture business and their own business.
Since there is no separate legal entity and venturers don't recognize the transactions separately, they do not maintain a separate set of books for joint venture. All the transactions of joint venture are recorded in their books only.

Following are the key features of JCO:

a. Each venturer has his own separate business.
b. There is no separate entity for joint venture business.
c. All venturers are creating their own assets and maintain them.
d. Each venturer record only his own transactions without any separate set of books maintained for the joint venture business.
e. Venturers use their assets for the joint venture business.
f. Venturers met the liabilities created by them for the joint venture business.
g. Venturers met the expenses of the joint venture business from their funds.
h. Any revenue generated or income earned from the joint venture is shared by the venturers as per the contract.

In respect of its interests in jointly controlled operations, a venturer should recognise in its separate financial statements and consequently in its consolidated financial statements:

(a) the assets that it controls and the liabilities that it incurs; and

(b) the expenses that it incurs and its share of the income that it earns from the joint venture.

However, the venturers may prepare accounts for internal management reporting purposes so that they may assess the performance of the joint venture.

Example 4

Mr. A (dealer in tiles and marbles), Mr. B (dealer in various building materials) and Mr. C (Promoter) enters into a joint venture business, where any contract for construction received will be completed jointly, say, Mr. A will supply all tiles and marbles, Mr. B will supply other materials from his godown and Mr. C will look after the completion of construction. As per the contractual agreement, they will share any profit/loss in a predetermined ratio. None of them are using separate staff or other resources for the joint venture business and neither do they maintain a separate account. Everything is recorded in their personal business only.

Venturer doesn't maintain a separate set of books but they record only their own transactions of the joint venture business in their books. Any transaction of joint venture recorded separately is only for internal reporting purpose. Once all transactions recorded in venturer financial statement, they don't need to be adjusted for in consolidated financial adjustment.

4.2 JOINTLY CONTROLLED ASSETS (JCA)

Separate legal entity is not created in this form of joint venture but venturer owns the assets jointly, which are used by them for the purpose of generating economic benefit to each of them. They take up any expenses and liabilities related to the joint assets as per the contract. We can conclude the following points:

- There is no separate legal identity.
- There is a common control over the joint assets.
- Venturers use this asset to derive some economic benefit to themselves.
- Each venturer incurs separate expenses for their transactions.
- Expenses on jointly held assets are shared by the venturers as per the contract.
- In their financial statement, venturer shows only their share of the asset and total income earned by them along with total expenses incurred by them.
- Since the assets, liabilities, income and expenses are already recognised in the separate financial statements of the venturer and consequently in its consolidated financial statements, no adjustments or other consolidation procedures are required in respect of these items when the venturer presents consolidated financial statements.
- Financial statements may not be prepared for the joint venture, although the venturers may prepare accounts for internal management reporting purposes so that they may assess the performance of the joint venture.

Example 5

ABC Ltd., BP Ltd. and HP Ltd. having the same point of oil refinery and same place of customers agreed to spread a pipeline from their unit to customers place jointly. They agreed to share the expenditure on the pipeline construction and maintenance in the ratio 3:3:4 respectively and the time allotted to use the pipeline was in the ratio 4:3:3 respectively.

For the joint venture, each venturer will record his share of joint assets as **classified according to the nature of the assets rather than as an investment** and any expenditure incurred or revenue generated will be recorded with other items similar to JCO.

Following are the few differences between JCO and JCA for better understanding:

- In JCO, venturers use their own assets for joint venture business but in JCA they jointly own the assets to be used in joint venture.
- JCO is an agreement to joint carry on the operations to earn income whereas, JCA is an agreement to jointly construct and maintain an asset to generate revenue to each venturer.
- Under JCO all expenses and revenues are shared at an agreed ratio, in JCA only expenses on joint assets are shared at the agreed ratio.

4.3 JOINTLY CONTROLLED ENTITIES (JCE)

- This is the format where **venturer creates a new entity** for their joint venture business. A jointly controlled entity is a joint venture which involves the establishment of a corporation, partnership or other entity in which each venturer has an interest.
- The entity operates in the same way as other enterprises, except that a contractual arrangement between the venturers establishes joint control over the economic activity of the entity.
- All the venturers pool their resources under new banner and this entity purchases its own assets, create its own liabilities, expenses are incurred by the entity itself and sales are also made by this entity.
- The net result of the entity is shared by the venturers in the ratio agreed upon in the contractual agreement.
- This contractual agreement also determines the joint control of the venturer. Each venturer usually contributes cash or other resources to the jointly controlled entity. These contributions are included in the accounting records of the venturer and are recognised in its separate financial statements as an investment in the jointly controlled entity.
- A jointly controlled entity maintains its own accounting records and prepares and presents financial statements in the same way as other enterprises in conformity with the requirements applicable to that jointly controlled entity.
- **The investors who don't have joint control over the entity recognized his share of net results and his investments in joint venture as per AS 13. In the consolidated financial statement it is recognized as per AS 13, AS 21 or AS 23 as appropriate.**

Example 6

A Ltd and B Ltd are two infrastructure companies operating in City A. The local authority has issued a tender to construct a metro stretch for ₹ 2,000 crore and had invited bidders to apply for the tender. A Ltd and B Ltd, jointly form a new entity AB Ltd that bids for the tender. All machinery and equipment will be the responsibility of A Ltd. All funding will be managed and controlled by B Ltd. Revenue and operating expenses will be shared jointly by A Ltd and B Ltd in the proportion of 60:40.

In the above example AB Ltd constitutes a Jointly Controlled Entity (JCE).

Example 7 (Jointly Controlled Entity (JCE))

Three separate aerospace companies form a separate entity, Aero Ltd, to jointly manufacture an aircraft. They carry responsibility for different areas of expertise, such as: manufacturing engines; manufacturing fuselage and wings; and aerodynamics.

The companies carry out different parts of the manufacturing process, each using its own resources and expertise in order to manufacture, market and distribute the aircraft jointly. The three entities share the revenues from the sale of aircraft and jointly incur expenses.

The revenues and common costs are shared, as agreed in the consortium contract. Parties also incur their own separate costs, such as labour costs, manufacturing costs, supplies, inventory of unused parts and work in progress. Each party recognises its separately incurred costs in full.

Aero Ltd maintains separate accounting records. The consortium agreement comprises the following:

Aero Ltd will invoice the customers on the investors' behalf. The allocation of revenue from the aircraft's sale is in proportion to the investors' interests.

All administrative costs incurred by Aero Ltd are shared by the parties in proportion to their interests; Aero Ltd will recharge these, with no additional margin.

The companies carry out different parts of the manufacturing process, each using its own resources and expertise to manufacture, market and distribute the aircraft jointly.

Each company incurs its own separate costs, such as labour costs, manufacturing costs, supplies, inventory of unused parts and work in progress. Each company recognises its separately incurred costs in full.

Difference Between Jointly Controlled Operation and Jointly Controlled Entity

S.No.	Jointly Controlled Operation (JCO)	Jointly Controlled Entity (JCE)
1.	No Separate Entity	Separate Entity
2.	Each Venturer records his own Shore of Assets/ Liabilities, Revenue/Expenses in its own Books.	Assets, Liabilities, Revenue & Expenses belongs to JCE. Venturer has right to share in Net Assets & Profits of JCE.
3.	No Separate Books Of JCO	Separate Books are maintained for JCE

4.	Here Venturer is recording in his own Books its share in Assets/Liability in JCO.	Here Venturer co. in its books is showing Investment in JCE

5. CONSOLIDATED FINANCIAL STATEMENTS OF A VENTURER

Proportionate consolidation is a method of accounting and reporting whereby a venturer's share of each of the assets, liabilities, income and expenses of a jointly controlled entity is reported as separate line items in the venturer's financial statements.

Proportionate consolidation method of accounting is to be followed except in the following cases:

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

b. Joint venture operates under severe long-term restrictions, which significantly impair its ability to transfer funds to the venturers.

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

From the date of discontinuing the use of the proportionate consolidation method,

a. If interest in entity is more than 50%, investments in such joint ventures should be accounted for in accordance with AS 21, Consolidated Financial Statement.

b. If interest is 20% or more but upto 50%, investments are to be accounted for in accordance with AS 23, Accounting for Investment in Associates in Consolidated Financial Statement.

c. For all other cases investment in joint venture is treated as per AS 13, Accounting for Investment.

d. For this purpose, the carrying amount of the investment at the date on which joint venture relationship ceases to exist should be regarded as cost thereafter.

Most of the provisions of Proportionate Consolidation Method are similar to the provisions of AS 21.

Example 8 (JCE & Proportionate Consolidation Method)

Balance Sheet of J Ltd. (31/3/24)

Equity Share Capital	10,00,000
Reserves and Surplus	6,00,000
Liabilities	14,00,000
	30,00,000
Non-Current Assets	18,00,000

Current Assets	12,00,000
	30,00,000

- J Ltd. is a J.V. Of A Ltd. & B Ltd. with 50% Investment by each.
- A Ltd. Invested in J Ltd. on 1/4/23, When R&S Balance of J Ltd. was 2,00,000/-
- Investment made by A Ltd. Was 6,50,000
- How A Ltd Shall accounts for this Investment in J Ltd. in its Consolidated Financial Statement.

Solution:-

A Ltd. (Venturer) Shall apply Proportionate Consolidation Method as under :-

Working Note 1 - Cost of Control as on DOA

Investment Cost	6,50,000
(-) 50% of Net Assets ESC 10 Lacs × 50% Pre-Acquisition Profit 2 Lacs × 50%	 (5,00,000) (1,00,000)
Goodwill	**50,000**

Working Note 2 - Share in Post Acquisition Profit of JCE :-

4,00,000 × 50% = 2,00,000

(Note: Minority Interest will never be Calculated)

A Ltd.

Consolidation B/s (Extract)

Equity Share Capital	XXX
Consolidated R&S :- A's Balance + Post Acquisition Profit Share	 XXX 2,00,000
Liability A Ltd. Share in JV	XXX 7,00,000
Non-Current Assets A Ltd. JV	 XXX 9,00,000
Goodwill Current Assets A Ltd. JV	50,000 XXX 6,00,000

6. TRANSACTION BETWEEN A VENTURER AND JOINT VENTURER

- When venturer transfers or sells assets to Joint Venture, the venturer should recognise only that portion of the gain or loss which is attributable to the interests of the other venturers.
- The venturer should recognise the full amount of any loss only when the contribution or sale provides evidence of a reduction in the net realisable value of current assets or an impairment loss.
- When the venturer from the joint venture purchases the assets, venturer will not recognized his share of profits in the joint venture of such transaction unless he disposes off the assets.
- A venturer should recognise his share of the losses resulting from these transactions in the same way as profits except that losses will be recognised in full immediately only when they represent a reduction in the net realisable value of current assets or an impairment loss.

Example 9

A and B established a separate vehicle i.e. entity J, wherein each operator has a 50% ownership interest and each takes 50% of the output. On formation of the joint venture, A contributed a property with fair value of ₹ 110 crore and agreed to contribute his experience over the years towards this venture; and B contributed equipment with a fair value of ₹ 120 crore. The carrying values of the contributed assets were ₹ 100 crore and ₹ 80 crore, respectively.

Answer

A's share in the fair value of assets contributed by entity B (50% × 120)	60
A's share in the carrying value of asset contributed by A to the joint venture (50% × 100)	(50)
Gain recognised by A	**10**

Example 10

A Ltd. is a Venturer has invested in a JV AB Ltd. with 50% Share. Another Venturer is B Ltd. A Ltd. sold one Asset to JV (AB Ltd.) whose cost is Rs. 1,00,000 and Sold at 1,25,000. How to treat this transaction in the books of A Ltd. and B Ltd. Describe with the help of Journal Entry.

Answer

A Ltd. has total Gain of 25,000 out of which 12,500 (50% share) earned from B Ltd. (i.e. Outside party) and rest 12,500 earned from itself. A Ltd. shall not record its own share of Gain earned from itself.

Books of JV (AB Ltd. – Purchaser)	**Books of B Ltd. (Venturer)**	**Books of A Ltd. (Seller and Venturer)**
Asset A/c Dr. 1,25,000 To A Ltd. 1,25,000	Share in JV's Asset Dr. 62,500 To Share in JV's Liability (A Ltd.) A/c 62,500	B Ltd. A/c Dr. 62,500 Share in JV's Asset Dr. 50,000 To Assets A/c 1,00,000 To Gain on Sale A/c 12,500

Example 11

AB Ltd. (JV of A Ltd. and B Ltd.) sold one Asset costing Rs. 1,00,000 to A Ltd. at 1,30,000. Pass necessary journal entries.

Answer

JV Ltd. has total Gain of 30,000 out of which 15,000 (50% share) of B Ltd. (i.e. Outside party) and 15,000 of A Ltd. A Ltd. shall not record its own share of Gain earned from itself.

Books of JV (AB Ltd. – Seller)	**Books of B Ltd. (Venturer)**	**Books of A Ltd. (Purchaser and Venturer)**
A Ltd. A/c Dr. 1,30,000 To Asset A/c 1,00,000 To Gain A/c 30,000	A Ltd. A/c Dr. 65,000 To Share in Asset A/c 50,000 To Gain A/c 15,000	Asset A/c Dr.1,15,000 To B Ltd. A/c 65,000 To Share in Asset A/c 50,000

7. (MCQ's from ICAI Material)

1. State which of the following statements are incorrect.

(i) The requirements relating to accounting for joint ventures in consolidated financial statements according to proportionate consolidation method, as contained in AS 27, applies only when consolidated financial statements are prepared by venturer.

(ii) The requirements relating to accounting for joint ventures in consolidated financial statements according to proportionate consolidation method, as contained in AS 27, applies irrespective whether consolidated financial statements are prepared by venturer or not.

(iii) An investor in joint venture, which does not have joint control, should report its interest in a joint venture in its consolidated financial statements in accordance with AS 13, AS 21 and AS 23as the case may be.

(a) Point (i) is incorrect.
(b) Point (ii) is incorrect.
(c) Point (iii) is incorrect.
(d) None of the above.

2. Identify which of the following is not a feature of a Jointly controlled operations (JCO):

a. Each venturer has his own separate business.
b. There is a separate entity for joint venture business.
c. Each venturer record only his own transactions without any separately set of books maintained for the joint venture business.
d. There is a common agreement between all of them.

3. Identify which of the following is/are not a feature of a Jointly controlled assets (JCA):

(i) There is a separate legal identity.
(ii) There is a common control over the joint assets.
(iii) Expenses on jointly held assets are shared by the venturers as per the contract.
(iv) In their financial statement, venturer shows only their share of the asset and total income earned by them along with total expenses incurred by them.

(a) Point no. (i) only.
(b) Point no. (i) and (iii).
(c) Point no. (iii) and (iv).
(d) Point (i) and (ii).

4. Identify which is/ are features of a Jointly controlled entity (JCE):

(i) Venturer creates a new entity for their joint venture business.
(ii) All the venturers pool their resources under new banner and this entity purchases its own assets, create its own liabilities, expenses are incurred by the entity itself and sales are also made by this entity.
(iii) The revenues and expenses of the entity is shared by the venturers in the ratio agreed upon in the contractual agreement.

(a) Point no. (i) only.
(b) Point no. (i) and (ii).
(c) Point no. (iii).
(d) Point no. (iii).

5. Identify the correct statements.

From the date of discontinuing the use of the proportionate consolidation method:

(i) If interest in entity is more than 50%, investments in such joint ventures should be accounted for in accordance with AS 21, Consolidated Financial Statements.

(ii) If interest is 20% or more but upto 50%, investments are to be accounted for in accordance with AS 23, Accounting for Investment in Associates in Consolidated Financial Statements.

(iii) For all other cases investment in joint venture is treated as per AS 13, Accounting for Investments.

(iv) For this purpose, the fair value of the investment at the date on which joint venture relationship ceases to exist should be regarded as cost thereafter.

(a) Point no. 1 and 2.
(b) Point no. 1, 2 and 3.
(c) Point no. 1, 2, 3 and 4.
(d) None of the above.

Answers	1	2	3	4	5
	b	b	a	c	b

Student Notes: -

25 ACCOUNTING STANDARD – 29 PROVISIONS, CONTINGENT LIABILITIES AND CONTINGENT ASSETS

"Failure is your best asset, complacency is your worst liability, and talent is your greatest capital."

1. NON-APPLICABILITY OF AS 29

AS 29 doesn't apply to:

(a) Executory contracts, except where the contract is onerous;

(b) financial instruments such as Shares, debentures, bonds etc.

(c) Deferred Tax Liabilities (AS 22);

(d) Lease Liabilities (AS 19, *Leases*);

(e) Employee benefit liabilities (AS 15, *Employee Benefits*); and

(f) Liabilities relating to Insurance contracts i.e. claims payable to customers.

(g) Provisions which are recognised as an adjustment to Assets such as Provision for depreciation, doubtful debts etc.

2. WHAT IS LIABILITY

Important Definitions:

- **Obligating Event:** an event that creates an obligation that results in an enterprise having no realistic alternative to settling that obligation.
- **Present Obligation:** if based on evidences available, its existence on the balance sheet date is considered probable i.e. more likely than not.
- **Possible Obligation:** if based on evidences available, its existence on the balance sheet date is considered not probable.

A Liability is a:

- Present Obligation of the Entity
- Arising from past events
- Settlement of which is possible only by outflow of resources (resources means any asset)

Past Events can create two types of Obligations:

- Legal obligation which arises from a contract or law
- Constructive Obligation which arises from Past Practices or Commitments. The occurrence of event creates valid expectations in other parties that "Entity will discharge its obligations". Valid expectations are created when an entity has committed or communicated to do something.

Examples of Past Events:

1. In respect of warranty provision, it would be the original sale.
2. In respect of contamination of land, it would be the original contamination.
3. In respect of Provision for dismantling or cleaning the oil rig, it would be when the oil rig is first built.

3. WHAT IS A PROVISION?

Provision is a:

- liability
- of uncertain timing or amount
- whose outflow can be estimated reliably

Note: *If there is no past event, then there is no liability,* and no provision should be recognized.

Formulae for Liability	Formulae for Provision
Past Event + Present Obligation + Outflow + Certainty of settlement	Past Event + Present Obligation + Outflow probability more than 50% + Uncertain Amt. or Timing + Estimation

Some Examples on Liabilities and Provisions:

Nature of obligation	Recognition as provision as per AS 29 (Yes/No)	Reasons
Amount payable for utilities like electricity, gas, etc.	No	Amount payable for utilities represents an accrual of liability to pay for services that have been received. The amount and timing of payment can be determined with a reasonable certainty. It is a liability.
Goods or services received, but not invoiced	No	It is a liability. In such a case, amount and timing of payment would be driven by the terms agreed with the supplier.

Warranty obligations	Yes	Warranty obligation represents the additional cost that the seller may have to incur to rectify product defects. This is in the nature of provision as there is an uncertainty associated with the amount and timing of the liability.
Damages claimed by customer for Rs. 20 Lacs	Yes	If Entity is disputing the amount of claim then there is uncertainty of amount payable. It is a Provision. However, when court has passed the judgement for Rs. 15 Lacs, it will become the liability.

4. HOW TO MEASURE A PROVISION?

The amount of the provision should be measured at the ***best estimate*** of the expenditure required to satisfy the obligation at the end of the reporting period.

Methods to Measure the Provision

1. ***Expected value method***: this method is used when there are more than 2 possible outcomes with probability of each outcome is given. In such a case we need to weight each outcome by its probability. Amount of provision will be equal to the "Weighted Average Amount"
2. ***The most likely outcome***: This method is suitable in the case there are two possible outcomes. The outcome with highest probability is taken as the amount of Provision.

Discounting (Present Value)

- When the amount of provision is required to be settled beyond 1 year then provision should be measured at Present Value of future outflow.
- In such a case, interest cost shall be recognised to unwind the discount over the period in Profit and Loss account.
- Discount rate should be taken pre-tax always.
- If there is risk of actual outflow more than present value, the amount of present value shall be increased by % of risk factor.

Examples of Best Estimate:

An entity faces a single legal claim, with a 40 percent likelihood of success with no cost and a 60 percent likelihood of failure with a cost of ₹1 million. Expected value is not valid in this case because the outcome will never be a cost of ₹600,000 (60 percent × ₹1 million); the outcome will either be nil or ₹1 million. AS 29 indicates that the provision may be estimated at the individual most likely outcome. In this example, it is more likely that a cost of ₹1 million will result and, therefore, a provision for ₹1 million should be recognised.

(Author Note - When there are only 2 outcomes use MOST LIKELY OUTCOME)

Other Important Points for Provision

1) Provision should not be made for "Future operating losses" since there is no past obligating event.

2) Provision should be recognised as soon as the obligating event takes place such as:
- Sale of Product with warranty, provision should be recognised on the date of sale
- PPE Installed with decommissioning cost, provision should be recognised as on PPE recognition date

3) Legal or Constructive obligation should be present as on Balance Sheet to create a Liability or Provision.

4) **Onerous Contracts:** Provision should be created at lower of:

a) Net Cost of Completing the Contract or

b) Penalty Cost of Cancellation of Contract

Note: Onerous contract means a contract in which the unavoidable cost (labor cost, material cost, variable production overheads) of meeting the obligation exceeds the expected benefits to be obtained. (e.g. Binding sale agreement or non-cancellable contract)

5) In case of Executory contracts, no provision is required.
Executory contracts are contracts under which
- Neither party has performed any of its obligations or
- Both parties have partially fulfilled their obligations to an equal extent.

6) When probability is given in the question then check if there is more than 50% chance of outflow then only provision is recognised.

7) If there is difficulty in estimating the provision amount due to unavailability of data or past experience, it is not justified to ignore the provision or not create the provision. Provision should be recognised based on industry data.

8) **Reimbursements:**
- If any expenditure is expected to be reimbursed by the other party and it is virtually certain to be received (more than 90% chance) then such reimbursement shall be recognised as a separate asset in the Balance Sheet.
- In the profit and loss account, provision can be presented net of reimbursement income.
- Amount of Reimbursement can never exceed the provision amount.

9) Provision should be reviewed at each balance sheet date and adjusted as per the current best estimate. If it is no longer required, then reverse the provision.

10) If the entity can avoid any future expenditure by its future actions, then NO provision is recognised for such expenditure. Example – future operating costs such as inspection of ships in the next 5 years, company can sale the ship before 5 years then no provision of inspection is required.

11) **Restructuring:**

a) Restructuring is a plan of management to *change the scope of business or the manner of conducting a business.*

Example: discontinuing a line of business or closure of one or two segments or operations

b) Provision for restructuring cost is required when:
   - There is a detailed formal plan for restructuring with relevant information in it (about business, location, employees, time schedule and expenditures)
   - A *valid expectation* related to restructuring has been raised in the affected parties.

c) Restructuring provision should include only the direct expenditures such as staff termination cost, compensation to customers, lease termination penalty etc.

d) Following costs are not considered for restructuring provision:
   - Training cost of employees
   - Cost of relocating asset from one location to another
   - Impairment cost

Example on Restructuring Cost:

Closure of a division – communication/ implementation before end of the reporting period

On 12th March, 20X1 (reporting date), the board of an entity decided to close down a division making a particular product. On 20th March, 20X1 a detailed plan for closing down the division was agreed by the board; letters were sent to customers warning them to seek an alternative source of supply and redundancy notices were sent to the staff of the division. It is assumed that a reliable estimate can be made of any outflows expected.

Present obligation as a result of a past obligating event – The obligating event is the communication of the decision to the customers and employees, which gives rise to a constructive obligation from that date, because it creates a valid expectation that the division will be closed.

An outflow of resources embodying economic benefits in settlement – Probable.

Conclusion – A provision is recognised at 31st March, 20X1 for the best estimate of the costs of closing the division.

IMPORTANT EXAMPLES ON PROVISION

1. Example on Legal requirement to fit smoke filters

Under new legislation, an entity is required to fit smoke filters to its factories by 30th September, 20X1. The entity has not fitted the smoke filters. It is assumed that a reliable estimate can be made of any outflows expected.

(a) At 31st March, 20X1, the end of the reporting period

Present obligation as a result of a past obligating event – There is no obligation because there is no obligating event either for the costs of fitting smoke filters or for fines under the legislation.

Conclusion – No provision is recognised for the cost of fitting the smoke filters.

(b) At 31st March, 20X2, the end of the reporting period

Present obligation as a result of a past obligating event – There is still no obligation for the costs of fitting smoke filters because no obligating event has occurred (the fitting of the filters). However, an obligation might arise to pay fines or penalties under the legislation because the obligating event has occurred (the non-compliant operation of the factory).

An outflow of resources embodying economic benefits in settlement – Assessment of probability of incurring fines and penalties by non-compliant operation depends on the details of the legislation and the stringency of the enforcement regime.

Conclusion – No provision is recognised for the costs of fitting smoke filters. However, a provision is recognised for the best estimate of any fines and penalties that are more likely than not to be imposed.

2. Example Contaminated land and constructive obligation

An entity in the oil industry (having 31st March year-end) causes contamination and operates in a country where there is no environmental legislation. However, the entity has a widely published environmental policy in which it undertakes to clean up all contamination that it causes. The entity has a record of honoring this published policy. It is assumed that a reliable estimate can be made of any outflows expected.

Present obligation as a result of a past obligating event- The obligating event is the contamination of the land, which gives rise to a constructive obligation because the conduct of the entity has created a valid expectation on the part of those affected by it that the entity will clean up contamination.

An outflow of resources embodying economic benefits in settlement- Probable.

Conclusion- A provision is recognised for the best estimate of the costs of clean-up.

3. Example Offshore oilfield

An entity operates an offshore oilfield where its licensing agreement requires it to remove the oil rig at the end of production and restore the seabed. 90% of the eventual costs relate to the removal of the oil rig and restoration of damage caused by building it, and 10% arise through the extraction of oil. At the end of the reporting period, the rig has been constructed but no oil has been extracted. It is assumed that a reliable estimate can be made of any outflows expected.

Present obligation as a result of a past obligating event – The construction of the oil rig creates a legal obligation under the terms of the license to remove the rig and restore the seabed and is thus an obligating event. At the end of the reporting period, 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 – Probable.

Conclusion – A provision is recognised for the best estimate of ninety per cent 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. The 10% of costs that arise through the extraction of oil are recognised as a liability when the oil is extracted

4. Example on Warranties

A manufacturer gives warranties at the time of sale to purchasers of its product. Under the terms of the contract for sale the manufacturer undertakes to make good, by repair or replacement, manufacturing defects that become apparent within three years from the date of sale. On past experience, it is probable (i.e., more likely than not) that there will be some claims under the warranties. It is assumed that a reliable estimate can be made of any outflows expected.

Present obligation as a result of a past obligating event – The obligating event is the sale of the product with a warranty, which gives rise to a legal obligation.

An outflow of resources embodying economic benefits in settlement – Probable for the warranties as a whole.

Conclusion – A provision is recognised for the best estimate of the costs of making good under the warranty products sold before the end of the reporting period

5. WHAT ARE CONTINGENCIES?

In Addition to Liabilities and Provisions, AS 29 deals with Contingent Liabilities and Contingent Assets.

Contingent Liabilities:

A ***contingent liability*** is either:

- ***A possible obligation*** (not present) from past event that will be confirmed by occurrence or non-occurrence of uncertain future event; or
- A present obligation from past event, but either:
  - The outflow of resources to satisfy this obligation is ***not probable*** (less than 50%), or
  - The amount cannot be reliably measured.

Treatment of Contingent Liability:

- Contingent liability shall not be recognised.
- It should be disclosed in Notes to Financial Statements.
- If the probability of outflow is less than 5% i.e. remote then disclosure is even not required.

> **Note:**
> When the entity is jointly and severely liable to settle the obligation along with another entity, in such case a part of the obligation which is expected to be met by other entity is treated as Contingent liability and the balance obligation is recognised either as Liability or Provision if it can be measured reliably.

Contingent Assets

A ***contingent asset*** is a ***possible asset*** arising from past events that will be confirmed by occurrence or non-occurrence of uncertain future events not fully under the entity's control.

Situations

Likelihood of outcome	Contingent liability	Contingent asset
Virtually certain (greater than 95% probability)	Recognise the Provision	Recognise the Asset
Probable (50% - 95% of probability)	Recognise the Provision	Disclose the Contingent Asset
Possible but not probable (5% - 50% of probability)	Disclose the Contingent Liability	Disclosure is not required
Remote (less than 5% probability)	Disclosure is not required	Disclosure is not required

6. (MCQ's from ICAI Material)

1. Which of the following best describes a provision?
   (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 setup to offset a contingent asset so that the effect on the statement of financial position is nil.
   (d) A provision is a possible obligation of uncertain amount.

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 1st 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?
   (a) A charge of ₹ 5,000
   (b) A credit of ₹ 5,000
   (c) A charge of ₹ 20,000
   (d) A credit of ₹ 25,000

3. Which of the following item does the statement bellowed scribe?
   "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"
   (a) A provision
   (b) A current liability
   (c) A contingent liability
   (d) Deferred tax liability

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.?
   (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 contingent liability of ₹ 5,00,000
   (d) Create a Provision of ₹ 5,00,000

Answers	1	2	3	4
	a	b	c	c

Student Notes: -

CA NOTES COMMUNITY NETWORK

Click on Icon	QR CODE	LINK
Join what's App group		CLICK HERE
Join Telegram Channel		CLICK HERE
Subscribe On Youtube		CLICK HERE
Follow us On Instagram		CLICK HERE

BE A PART OF CNC FAMILY

CNC – CA NOTES COMMUNITY

Mail at (for complaints/feedback) – canotescommunity@gmai.com