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CA INTER
Advanced Accounting
Accounting Standards - Part 2

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FRAMEWORK FOR PREPARATION AND PRESENTATION OF FINANCIAL STATEMENTS

This framework provides the fundamental basis for development of new standards as also for review of existing standards. This framework also explains components of financial statements, users of financial statements, qualitative characteristics of financial statements and elements of financial statements.

The framework also explains concepts of capital, capital maintenance and determination of profit.

INTRODUCTION

The development of accounting standards or any other accounting guidelines need a foundation of underlying principles. (ASB) of ICAI issued a framework in July, 2000 which provides the fundamental basis for development of new standards as also for review of existing standards.

Nothing in the framework overrides any specific Accounting Standard. In case of conflict between an Accounting Standard and the framework, the requirements of the Accounting Standard will prevail over those of the framework.

The principal areas covered by the framework are as follows:

- (a) Components of financial statements;
- (b) Objectives of financial statements;
- (c) Assumptions underlying financial statements;
- (d) Qualitative characteristics of financial statements;
- (e) Elements of financial statements;

f) Criteria for recognition of elements in financial statements;

(g) Concepts of Capital and Capital Maintenance

COMPONENTS OF FINANCIAL STATEMENTS

A complete set of financial statements normally consists of a Balance Sheet, a Statement of Profit and Loss and a Cash Flow Statement together with notes, other statements and explanatory materials that form an integral part of the financial statements.

All components of the financial statements are interrelated because they reflect different aspects of same transactions or other events. Although each statement provides information that is different from each other, none in isolation is likely to serve any single purpose nor can anyone provide all information needed by a user.

The major information contents of different components of financial statements are explained as below:

Balance Sheet portrays value of economic resources controlled by an enterprise. It also provides information about liquidity and solvency of an enterprise which is useful in predicting the ability of the enterprise to meet its financial commitments as they fall due.

Statement of Profit and Loss presents the result of operations of an enterprise for an accounting period, i.e. it depicts the performance of an enterprise, in particular its profitability.

Cash Flow Statement shows the way an enterprise has generated cash and the way they have been used in an accounting period and helps in evaluating the investing, financing and operating activities during the reporting period.

Notes and other statements present supplementary information explaining different items of financial statements. For example, they may contain additional information that is relevant to the needs of users about the items in the balance sheet and statement of profit and loss. They include various other disclosures such as disclosure of accounting policies, segment reporting, related party disclosures, earnings per share, etc.

OBJECTIVES AND USERS OF FINANCIAL STATEMENTS

The objective of financial statements is to provide information about the financial position, performance and cash flows of an enterprise that is useful to a wide range of users in making economic decisions.

The framework identifies seven broad groups of users of financial statements.

All users of financial statements expect the statements to provide useful information needed to make economic decisions. The financial statements provide information to suit the common needs of most users. However, they cannot and do not intend to provide all information that may be needed, e.g. they do not provide non-financial data even if they may be relevant for making decisions.

The aforesaid users use financial statements in order to satisfy some of their information needs. These needs may include the following:

- a) **Investors** - The providers of risk capital are concerned with the risk inherent in, and return provided by, their investments. They are also interested in information which enables them to assess the ability of the enterprise to pay dividends.
- b) **Employees** - Employees and their representative groups are interested in information about the stability and profitability of their employers. They are also interested in information which enables them to assess the ability of the enterprise to provide remuneration, retirement benefits and employment opportunities.
- c) **Lenders** - Lenders are interested in information which enables them to determine whether their loans, and the interest attaching to them, will be paid when due
- d) **Suppliers and other trade creditors** - Suppliers and other creditors are interested in information which enables them to determine whether amounts owing to them will be paid when due. Trade creditors are likely to be interested in an enterprise over a shorter period than lenders unless they are dependent upon the continuance of the enterprise as a major customer.

- e) **Customers** - Customers have an interest in information about the continuance of an enterprise, especially when they have a long term involvement with, or are dependent on, the enterprise for their goods and services.
- f) **Governments and their agencies** - Governments and their agencies are interested in the allocation of resources and, therefore, the activities of enterprises. They also require information in order to regulate the activities of enterprises and determine taxation policies, and to serve as the basis for determination of national income and similar statistics.
- g) **Public** - Enterprises affect members of the public in a variety of ways. For example, enterprises may make a substantial contribution to the local economy in many ways including the number of people they employ and their patronage of local suppliers. Financial statements may assist the public by providing information about the trends and recent developments in the prosperity of the enterprise and the range of its activities.

FUNDAMENTAL ACCOUNTING ASSUMPTIONS

As per the framework, there are three fundamental accounting assumptions:

(A) **Going concern**

These are assumptions, i.e, the users of financial statements believe that the same has been considered while preparing the financial statements. That is why, as long as financial statements are prepared in accordance with these assumptions, no separate disclosure in financial statements would be necessary.

If nothing has been written about the fundamental accounting assumption in the financial statements, then it is assumed that they have already been followed in their preparation of financial statements.

However, if any of the above-mentioned fundamental accounting assumption is not followed then this fact should be specifically disclosed.

Financial statements are normally prepared on the assumption that an enterprise will

continue in operation in the foreseeable future and neither there is an intention, nor there is a need to materially curtail the scale of operations.

(b) **Accrual Basis:** According to AS 1, revenues and costs are accrued, that is, recognised as they are earned or incurred (and not as money is received or paid) and recorded in the financial statements of the periods to which they relate.

Further Section 128(1) of the Companies Act, 2013 makes it mandatory for companies to maintain accounts on accrual basis only. It is not necessary to expressly state that accrual basis of accounting has been followed in preparation of a financial statement. In case, any income/ expense is recognised on cash basis, the fact should be stated.

Profit and Loss Account of the trader by two basis of accounting are shown below. A look at the cash basis Profit and Loss Account will convince any reader of the irrationality of cash basis of accounting.

(C) **Consistency:** It is assumed that accounting policies are consistent from one period to another. The consistency improves comparability of financial statements through time. According to Accounting Standards, an accounting policy can be changed if the change is required

(i) by a statute or (ii) by an Accounting Standard or (iii) for more appropriate presentation of financial statements.

QUALITATIVE CHARACTERISTICS OF FINANCIAL STATEMENTS

The qualitative characteristics are attributes that improve the usefulness of information provided in financial statements. The framework suggests that the financial statements should observe and maintain the following four qualitative characteristics as far as possible within limits of reasonable cost/ benefit.

These attributes can be explained as:

1. **Understandability:** The financial statements should present information in a manner as to be readily understandable by the users with reasonable knowledge of business and economic activities and accounting.
2. **Relevance:** It is not right to think that more information is always better.. A mass

of irrelevant information creates confusion and can be even more harmful than non-disclosure. The financial statements should contain relevant information only. Information, which is likely to influence the economic decisions by the users, is said to be relevant. Such information may help the users to evaluate past, present or future events or may help in confirming or correcting past evaluations. The relevance of a piece of information should be judged by its Materiality

3. **Reliability:** To be useful, the information must be reliable; that is to say, they must be free from material error and bias. The information provided are not likely to be reliable unless:

Transactions and events reported are faithfully represented.

Transactions and events are reported on the principle of 'substance over form

The reporting of transactions and events are neutral, i.e. free from bias.

Prudence is exercised in reporting uncertain outcome of transactions or events.

4. **Comparability:** Comparison of financial statements is one of the most frequently used and most effective tools of financial analysis. The financial statements should permit both inter-firm and intra-firm comparison. One essential requirement of comparability is disclosure of financial effect of change in accounting policies.

ELEMENTS OF FINANCIAL STATEMENTS

The framework classifies items of financial statements in five broad groups depending on their economic characteristics.

1. **Asset:** An asset is a resource controlled by the enterprise as a result of past events from which future economic benefits are expected to flow to the enterprise. The following points must be considered while recognising an asset:

The resource regarded as an asset, need not have a physical substance. The resource may represent a right generating future economic benefit,

e.g. patents, copyrights, trade receivables. An asset without physical substance can be either intangible asset, e.g. patents and copyrights or monetary assets, e.g. trade receivables. The monetary assets are money held and assets to be received in fixed or determinable amounts of money.

2. **Liability:** A liability is a present obligation of the enterprise arising from past events, the settlement of which is expected to result in an outflow of a resource embodying economic benefits. The following points may be noted:
- (a) A liability is a present obligation, i.e. an obligation the existence of which, based on the evidence available on the balance sheet date is considered probable. For example, an enterprise may have to pay compensation if it loses a damage suit filed against it. The damage suit is pending on the balance sheet date. The enterprise should recognise a liability for damages payable by a charge against profit if it is probable that the enterprise will lose the suit and if the amount of damages payable can be ascertained with reasonable accuracy.
- " Present obligation may be legally enforceable as a consequence of a binding contract or statutory requirement or they may arise from normal business practice, custom and a desire to maintain good business relations or act in an equitable manner.
3. **Equity:** Equity is defined as residual interest in the assets of an enterprise after deducting all its liabilities. It is important to avoid mixing up liabilities with equity. Equity is the excess of aggregate assets of an enterprise over its aggregate liabilities. In other words, equity represents owners' claim consisting of items like capital and reserves, which are clearly distinct from liabilities, i.e. claims of parties other than owners. The value of equity may change either through contribution from / distribution to equity participants or due to income earned /expenses incurred.
4. **Income:** Income is increase in economic benefits during the accounting period in the form of inflows or enhancement of assets or decreases in liabilities that result in increase in equity other than those relating to contributions from equity participants. The definition of income encompasses revenue and gains. Revenue is an income that arises in the ordinary course of activities of the enterprise, e.g. sales by a trader. Gains are income, which may or may not arise in the ordinary course of activity of the enterprise, e.g. profit on disposal of Property, Plant and Equipment. Gains are showed separately in the statement of profit and loss because this knowledge is useful in assessing performance of the enterprise.
5. **Expense:** An expense is decrease in economic benefits during the accounting period in the form of outflows or depletions of assets or incurrence of liabilities that result in decrease in equity other than those relating to distributions to equity participants.

The definition of expenses encompasses expenses that arise in the ordinary course of activities of the enterprise, e.g. wages paid. Losses may or may not arise in the ordinary course of activity of the enterprise, e.g. loss on disposal of Property, Plant and Equipment. Losses are separately shown in the statement of profit and loss because this knowledge is useful in assessing performance of the enterprise.

MEASUREMENT OF ELEMENTS OF FINANCIAL STATEMENTS

Measurement is the process of determining money value at which an element can be recognised in the balance sheet or statement of profit and loss. The framework recognises four alternative measurement bases. These bases relate explicitly to the valuation of assets and liabilities. The valuation of income or expenses, i.e. profit is implied, by the value of change in assets and liabilities.

A brief explanation of each measurement basis is as follows:

1. **Historical Cost:** Historical cost means acquisition price. For example, the businessman paid ₹ 7,00,000 to purchase the machine, its acquisition price including installation charges is ₹ 8,00,000. The historical cost of machine would be ₹ 8,00,000.
2. **Current Cost:** Current cost gives an alternative measurement basis. Assets are carried at the amount of cash or cash equivalent that would have to be paid if the same or an equivalent asset was acquired currently. Liabilities are carried at the undiscounted amount of cash or cash equivalents that would be required to settle the obligation currently.
3. **Realisable (Settlement) Value:** For assets, this is the amount of cash or cash equivalents currently realisable on sale of the asset in an orderly disposal. For liabilities, this is the undiscounted amount of cash or cash equivalents expected to be paid on settlement of liability in the normal course of business.
4. **Present Value:** Assets are carried at the present value of the future net cash inflows that the item is expected to generate in the normal course of business. Liabilities are carried at the present value of the future net cash outflows that are expected to be required to settle the liabilities in the normal course of business.

CAPITAL MAINTENANCE

Capital refers to net assets of a business. Since a business uses its assets for its operations, a fall in net assets will usually mean a fall in its activity level. It is therefore important for any business to maintain its net assets in such a way, as to ensure continued operations at least at the same level year after year. In other words, dividends should not exceed profit after appropriate provisions for replacement of assets consumed in operations. For this reason, the Companies Act does not permit distribution of dividend without providing for depreciation on Property, Plant and Equipment. Unfortunately, this may not be enough in case of rising prices.

A business should ensure that Retained Profit (RP) is not negative, i.e. closing equity should not be less than capital to be maintained, which is sum of opening equity and capital introduced.

It should be clear from above that the value of retained profit depends on the valuation of assets and liabilities. In order to check maintenance of capital, i.e. whether or not retained profit is negative, we can use any of following three bases:

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

Financial capital maintenance at current purchasing power: Under this convention, opening and closing equity at historical costs are restated at closing prices using average price indices. (For example, suppose opening equity at historical cost is ₹3,00,000 and opening price index is 100. The opening equity at closing prices is ₹3,60,000 if closing price index is 120). A positive retained profit by this method means the business has enough funds to replace its assets at average closing price.

This may not serve the purpose because prices of all assets do not change at average rate in real situations. For example, price of a machine can increase by 30% while the average increase is 20%.

Physical capital maintenance at current costs: Under this convention, the historical costs

of opening and closing assets are restated at closing prices using specific price indices applicable to each asset. The liabilities are also restated at a value of economic resources to be sacrificed to settle the obligation at current date, i.e. closing date. The opening and closing equity at closing current costs are obtained as an excess of aggregate of current cost values of assets over aggregate of current cost values of liabilities. A positive retained profit by this method ensures retention of funds for replacement of each asset at respective closing prices. pening equity at

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AS 15 - EMPLOYEE BENEFITS

EMPLOYEE BENEFITS

AS 15 deals with all kinds of employee benefits which include:

- (i) Short term employee benefits such as wages
- (ii) Post-Employment benefits such as gratuity
- (iii) Other Long-Term Employee Benefits such as sabbatical leave
- (iv) Termination benefits

AS 15 was issued by ICAI and came into effect with regards to accounting periods on or after April 1, 2006.

APPLICABILITY OF AS 15

1. Accounting Standard 15 is applicable to the following enterprises at any time during the accounting period.
 - Enterprises having their equity or debt securities listed whether in India or outside India
 - The enterprises undergoing the process of getting their equity or debt listed
 - Banks including Cooperative Banks
 - Financial Institutions
 - Enterprises undertaking Insurance business
 - All enterprises including industrial, commercial and business reporting enterprises having an annual turnover of more than Rs 50 Crores in the preceding accounting period based on the audited financial statements
 - Enterprises including industrial, commercial and business reporting enterprises having borrowings including public deposits of more than Rs 10 Crores at any time during the accounting period.
 - Holding as well as subsidiary enterprises of any of the ones mentioned above at any time during the accounting period.
2. All the enterprises that do not form part of the ones mentioned above under point A and have 50 or more persons on an average employed during the year. There are however exceptions to such enterprises which can be referred to in AS 15 (Revised 2005).

3. Enterprises that do not form part of categories mentioned in point A above and have less than 50 persons on an average employed during the year. There are however exceptions to such enterprises which can be referred to in AS 15 (Revised 2005).

EMPLOYEE BENEFITS

As per Accounting Standard 15, an employee is defined as a person rendering service to an enterprise on a full-time, part time, permanent, casual or temporary basis. For the purpose of AS 15, employees include whole time directors and other management personnel.

Furthermore, AS 15 deals with employee benefits which include:

1. Short-Term Employee Benefits. These include wages, salaries, social security contributions (such as contribution to an insurance company made by an employer in order to pay for the medical care of its employees), paid annual leave, profit-sharing and bonuses (if such bonuses are payable within 12 months of the end of the period) and non-monetary benefits (these include cars, housing, medical care and free/subsidized goods or services) for current employees.
2. Post-Employment Benefits. These include gratuity, pensions, other retirement benefits, post employment life insurance and post employment medical care.
3. Other Long-Term Employee Benefits. These include sabbatical leave, jubilee or other long-term service benefits, long-term disability benefits. Furthermore, if such benefits are not paid wholly within 12 months after the end of the period, then, profit-sharing, bonuses and deferred compensation would be paid.
4. Termination Benefits. That is benefits given to an employee when he leaves the organization.

SHORT-TERM EMPLOYEE BENEFITS

As per AS 15, Short-Term employee benefits consist of:

- Wages, salaries and social security contributions
- Short-Term paid absences such as paid annual leave where such absences are expected to take place within 12 months after the end of the period during which the employees provide related employee service.
- Profit-Sharing and Bonuses payable within 12 months after the end of the period during which employees provide related services.
- Non-Monetary Benefits including medical care, housing, cars and free/subsidized goods or services for current employees.

RECOGNITION AND MEASUREMENT

Whenever an employee provides service to an enterprise during an accounting period, the enterprise must identify the un-discounted amount of short-term employee benefits that are anticipated to be paid for that service.

Accordingly, such employee benefits are recognized as:

- (i) a liability after deducting any amount of employee benefit that has already been paid. Furthermore, if the amount of employee benefits paid is more than the un-discounted amount of benefits, the enterprise is required to identify such an excess as a prepaid expense. That is, as an asset. This prepayment should be identified as an asset in such a way that it results in reduction in future employee benefit payment or cash refund.
- (ii) as an expense till the time any other accounting standard permits benefits to be included in the cost of the asset.

POST-EMPLOYMENT BENEFITS

As mentioned above, Post-Employment Benefits consist of:

- (i) Retirement Benefits – eg. pension and gratuity
- (ii) Other Benefits – e.g. post-employment life insurance and post-employment medical care

Now, such benefits are extended to the employees via arrangements known as post employment benefit plans.

Any enterprise applies accounting standard 15 to all such arrangements irrespective of the fact whether such arrangements involve establishment of a separate entity to receive contributions and pay benefits.

Furthermore, these post-employment benefit plans are classified into:

- (i) Defined Contribution Plans
- (ii) Defined Benefit Plans

Such a classification depends upon the economic substance of the plan as obtained from its principal terms and conditions.

(I) What Are Defined Contribution Plans?

As per Defined Contribution Plans, an enterprise's obligation is restricted only to the amount that it agrees to contribute to such a fund. That is to say, the amount of Post-Employment Benefits received by an employee is based on:

- (i) the amount of contributions made by such an enterprise as well as the employee towards this post employment benefit plan or the insurance company and

- (ii) investment returns earned on such contributions

Thus, the actuarial risk, that is benefits would be less than expected and investment risk, that is, assets invested would not be sufficient to pay for the expected benefits, both fall on the employee.

Furthermore, there can be cases where the employee benefit obligation is not just restricted to the amount that such an enterprise agrees to contribute towards the fund. These include the cases when the enterprise has an obligation via:

- (i) a plan benefit formula that is not linked only to the amount of contributions
- (ii) guarantee of a specified returns on the contribution either indirectly via a plan or directly
- (iii) informal practices that lead to an obligation

Recognition and Measurement

Whenever an employee provides service to an enterprise during an accounting period, the enterprise must identify the contribution payable to a defined contribution plan in exchange for that service.

Such employee benefits are recognized as:

- (i) a liability after deducting any amount of contribution already been paid. Furthermore, if the amount of contribution already paid is more than the contribution due for service before the date of the balance sheet, such excess contribution should be recognized as an asset. This prepayment should be identified as an asset in such a way that it results in reduction in future employee benefit payment or cash refund.
- (ii) as an expense till the time any other accounting standard permits contribution to be included in the cost of the asset.

Furthermore, there can be cases where contributions made to the Defined Contribution Plan do not become due wholly within 12 months after the end of the period after which the employees provide related service.

In such cases, contributions should be discounted using Discount rate as specified in the accounting standard 15.

(II) What Are Defined Benefit Plans?

As per Defined Benefit Plans the enterprise has an obligation to extend the agreed benefits to both the current as well as the former employees. Furthermore, the actuarial risk, that is benefits would cost more than expected and investment risk, both fall on the enterprise.

Accounting Treatment for Defined Benefit Plans is complex. This is because actuarial assumptions are needed in order to measure the obligation expense. Furthermore, there are also chances of actuarial gains and losses.

In addition to this, the obligations are measured on discounted basis as such an obligation may be settled years after employees provide the related service.

Therefore, the reporting enterprise may need the services of a qualified actuary in order to measure obligations under Defined Benefit Plans.

Recognition and Measurement

Defined Benefit Plans may either be unfunded or wholly or partly funded via contributions made by the enterprise and at times made by its employees into an entity or a fund. Such a fund is legally different from the reporting enterprise from which the employees benefits are paid.

Accordingly, the payment of such funded benefits depends not only on the financial position as well as the investment performance of the fund but also on the enterprises potentiality to provide for any shortfall of the assets of the fund.

As a result, the expense identified for Defined Benefit Plan is not mandatorily the amount of contribution that is outstanding for the given period.

Accounting for the Obligation Under a Defined Benefit Plan

The enterprise should account for not only its legal obligation as per the formal terms of the Defined Benefit Plan but also for any other obligation that emerges out of enterprises' informal practices.

Informal practices may lead to an obligation where the enterprise has no other option but to pay for the employee benefits.

Balance Sheet

The amount to be recognized as a defined benefit liability in the balance sheet should be the net total of the following amounts:

- (i) present value of the defined benefit obligation at the balance sheet date
- (ii) subtract any past service cost not yet recognized
- (iii) subtract the fair value at the balance sheet date of plan assets (if any) out of which the obligations are to be settled directly

Statement of Profit and Loss

The enterprise need to recognize the total of the following amounts in the P&L Statement:

- (i) current service cost

- (ii) interest cost
- (iii) expected return on any plan assets and on any reimbursement rights
- (iv) actuarial gains and losses
- (v) past service cost to the extent the accounting standard requires an enterprise to recognize it
- (vi) effect of any curtailments or settlements

ACTUARIAL ASSUMPTIONS

The actuarial assumptions are nothing but an enterprise's best estimates of the variables that would determine the cost of providing post-employment benefits. These assumptions comprise of:

- (i) Demographic assumptions about the future characteristics of current and former employees eligible for benefits. These include:
 - mortality, both during and after employment
 - rates of employee turnover, disability and early retirement
 - proportion of employees eligible for the benefits under the plan
 - claim rates under medical plans
- (ii) financial assumptions that deal with aspects like:
 - discount rate
 - future salary and benefit levels
 - future medical costs, including, where material, the cost of administering claims and benefit payments in case of medical benefits
 - expected rate of return on plan assets

OTHER LONG-TERM EMPLOYEE BENEFITS

Other long-term benefits are nothing but the employee benefits that do not become due wholly due within 12 months subsequent to the end of the period in which the employees offer the related service.

These benefits include:

- (i) long-term compensated absences such as long-service or sabbatical leave
- (ii) jubilee or other long-service benefits
- (iii) long-term disability benefits
- (iv) profit-sharing and bonuses which are payable twelve months or more after the end of the period in which the employees offered the related service
- (v) deferred compensation paid twelve months or more after the end of the period in which it is earned

Recognition and Measurement

Balance Sheet

The amount to be recognised as a defined benefit liability should be the net total of the following amounts:

- (i) present value of the defined benefit obligation at the balance sheet date
- (ii) subtract the fair value at the balance sheet date of plan assets (if any) out of which the obligations are to be settled directly

Statement of Profit and Loss

The enterprise need to recognize the total of the following amounts as expense in the P&L Statement for other long-term employee benefits:

- (i) current service cost
- (ii) interest cost
- (iii) expected return on any plan assets and on any reimbursement rights
- (iv) actuarial gains and losses
- (v) past service cost to the extent the accounting standard requires an enterprise to recognise it
- (vi) effect of any curtailments or settlements

TERMINATION BENEFITS

As per AS 15, Termination Benefits refer to the employee benefits that are payable as a result of:

- (i) an enterprise's decision to put an end to an employee's employment before the normal retirement date
- (ii) employee's decision to retire voluntarily in lieu of such benefits

AS 15 takes termination benefits different from other employee benefits. This is because the event that results in such an obligation is termination and not employee service.

Recognition and Measurement

The enterprise must identify the termination benefits as a liability and an expense if only:

- (i) the enterprise has a present obligation on account of a past event
- (ii) it is possible that the outflow of resources that symbolize economic benefits would be needed to settle the obligation
- (iii) amount of estimate can be estimated reliably

ILLUSTRATION QUESTION

Illustration 1

What are the kinds of employees covered in the revised AS 15 and whether a formal employer employee relationship is necessary or not, for benefits to be covered under the Standard?

Solution 1

The Standard does not define the term “employee”. Paragraph 6 of the Standard states that ‘an employee may provide services to an enterprise on a full time, part time, permanent, casual or temporary basis and the term would also include the whole-time directors and other management personnel. The Standard is applicable to all forms of employer employee relationships. There is no requirement for a formal employer employee relationship. Several factors need to be considered to determine the nature of relationship.

Generally, ‘outsourcing contracts’ may not meet the definition of employer - employee relationship. However, such contracts need to be carefully examined to distinguish between a “contract of service” and a “contract for services”. A ‘contract for services’ implies a contract for rendering services, e.g., professional or technical services which is subject to limited direction and control whereas a ‘contract of service’ implies a relationship of an employer and employee, and the person is obliged to obey orders in the work to be performed and as to its mode and manner of performance.

Illustration 2

Whether an enterprise is required to provide for employee benefits arising from informal practices?

Solution 2

Paragraph 3(c) of the Standard defines employee benefits to include those informal practices that give rise to an obligation where the enterprise has no realistic alternative but to pay employee benefits. The historical pattern of granting such benefits, the expectation created and the impact on the relationship with employees in the event such benefit is withdrawn should be considered in determining whether the informal practice gives rise to a benefit covered by the Standard. For example, where an employer has a practice of making a lumpsum payment on occasion of a festival or regularly grants

advances against informal benefits to employees it would be necessary to provide for such benefits.

Careful judgement should be applied in assessing whether an obligation has arisen particularly in instances where an enterprise's practice is to provide improvements only during the collective bargaining process and not during any informal process. If the employer has not set a pattern of benefits that can be projected reliably to give rise to an obligation there is no requirement to provide for the benefits.

However, if the practice established by an employer was that of a consistent benefit granted either as part of union negotiations or otherwise that clearly established a pattern (e.g., a cost of living adjustment or fixed rupee increase), it could be concluded that an obligation exists and that those additional benefits should be included in the measurement of the benefit obligation.

Employee benefits include:

- (a) Short-term employee benefits (e.g., wages, salaries, paid annual leave and sick leave, profit sharing bonuses etc. (payable within 12 months of the year-end) and non-monetary benefits for current employees.
- (b) Post-employment benefits (e.g., gratuity, pension, provident fund, post-employment medical care etc.).
- (c) long-term employee benefits (e.g., long-service leave, long-term disability benefits, bonuses not wholly payable within 12 months of the year end etc.), and
- (d) termination benefits (e.g. VRS payments)

The Standard lays down recognition and measurement criteria and disclosure requirements for the above four types of employee benefits separately.

Illustration 3

Entity XY is required to pay salary of ₹ 2 crore for the year 20X1-X2. It actually paid a salary of ₹ 1.90 crore up to 31st March 20X2, and balance in April 20X2. Determine the actual costs to be recognized in the year 20X1-X2 and any amounts to be shown through balance sheet.

Solution 3

Total expense for the year (20X1-X2)	₹ 2 crore
Amount to be shown under liability (unpaid)	₹ 2 crore – 1.90 ₹crore
	= ₹ 10 lakhs

Illustration 4

Whether an entitlement to earned leave which can be carried forward to future periods is a short -term employee benefit or a long-term employee benefit.

Solution 4

Paragraph 7.2 of the Standard defines ‘Short-term’ benefits as employee benefits (other than termination benefits) which fall due wholly within twelve months after the end of the period in which the employees render the related service. Paragraph 8(b) of the Standard illustrates the term ‘Short -term benefits’ to include “short term compensated absences (such as paid annual leave) where the absences are expected to occur within twelve months after the end of the period in which the employees render the related employee service”.

Paragraph 7.2 of the Standard uses “falls due” as the basis, paragraph 8(b) of the Standard uses “expected to occur” as the basis to illustrate classification of short term compensated absences. A reading of paragraph 8(b) together with paragraph 7.2 would imply that the classification of short -term compensated absences should be only when absences have “fallen due” and are also “expected to occur”. In other words, where employees are entitled to earned leave which can be carried forward to future periods, the benefit would be a ‘short-term benefit’ provided the employee is entitled to either encash or utilise the benefit during the twelve months after the end of the period when the employee became entitled to the leave and is also expected to utilise the leave.

Where there are restrictions on encashment and/or availment, clearly the compensated absence has not fallen due and the benefit of compensated absences is more likely to be a long-term benefit. For example, where an employee has 100 days of earned leave which he is entitled to an unlimited carry forward, but the rules of the enterprise allow him to encash/utilise only 30 days during the next twelve months, the benefit would be considered as a ‘long-term’ benefit. In some situations, where there is no restriction but the absence is not expected to wholly occur in the next twelve months, the benefit should be considered as ‘long-term’. For example, where an employee has 400 days carry forward earned leave and the past pattern indicates that the employees are unlikely to avail / encash the entire carry forward during the next twelve months, the benefit would not be ‘short-term’.

Whilst it is necessary to consider the earned leave which “falls due”, the pattern of actual utilisation/encashment by employees, although reflective of the behavioural pattern of employees, does determine the status of the benefit, i.e., whether ‘short-term’ or ‘long-term’. The value of short-term benefits should be determined without discounting and if the benefit is determined as long-term, it would be recognised and measured as “Other long-term benefits” in accordance with paragraph 129 of the Standard.

The categorisation in ‘short-term’ or ‘long-term’ employee benefits should be done on the basis of the overall behavioural pattern of all the employees of the enterprise and not on individual basis.

Illustration 5

In case an enterprise allows unutilised employee benefits, e.g., medical care, leave travel, etc., to be carried forward, whether it is required to recognise a provision in respect of carried forward benefits.

Solution 5

A provision should be recognised for all benefits (conditional or unconditional) which an employee becomes entitled to as a result of rendering of the service and should be recorded as part of the cost of service rendered during the period in which the service was rendered which resulted the entitlement. In estimating the cost of such benefit the probability of the employee availing such benefit should be considered.

Illustration 6

Omega Limited belongs to the engineering industry. The company received an actuarial valuation for the first time for its pension scheme which revealed a surplus of ₹ 6 lakhs. It wants to spread the same over the next 2 years by reducing the annual contribution to ₹ 2 lakhs instead of ₹ 5 lakhs. The average remaining life of the employees is estimated to be 6 years. You are required to advise the company on the following items from the viewpoint of finalization of accounts, taking note of the mandatory accounting standards.

Solution 6

According to AS 15 (Revised 2005) ‘Employee Benefits’, actuarial gains and losses should be recognized immediately in the statement of profit and loss as income or expense. Therefore, surplus amount of ₹ 6 lakhs is required to be credited to the profit and loss statement of the current year.

Illustration 7

As on 1st April, 20X1 the fair value of plan assets was ₹ 1,00,000 in respect of a pension plan of Zeleous Ltd. On 30th September, 20X1 the plan paid out benefits of ₹ 19,000 and received inward contributions of ₹ 49,000. On 31st March, 20X2 the fair value of plan assets was ₹ 1,50,000 and present value of the defined benefit obligation was ₹ 1,47,920. Actuarial losses on the obligations for the year 20X1- 20X2 were ₹ 600. On 1st April, 20X1, the company made the following estimates, based on its market studies, understanding and prevailing prices.

	%
Interest & dividend income, after tax payable by the fund	9.25
Realised and unrealised gains on plan assets (after tax)	2.00
Fund administrative costs	(1.00)
Expected Rate of Return	10.25

You are required to find the expected and actual returns on plan assets.

Solution 7

Computation of Expected and Actual Returns on Plan Assets

	₹
Return on ₹ 1,00,000 held for 12 months at 10.25%	10,250
Return on ₹ 30,000 (49,000 - 19,000) held for six months at 5% (equivalent to 10.25% annually, compounded every six months)	1,500
Expected return on plan assets for 20X1-20X2	11,750
Fair value of plan assets as on 31 March, 20X2	1,50,000
Less: Fair value of plan assets as on 1 April, 20X1	1,00,000
Contributions received	<u>49,000</u>
	1,000
Add: Benefits paid	<u>19,000</u>
Actual return on plan assets	<u>20,000</u>

Alternatively, the above question may be solved without giving compound effect to rate of return.

Illustration 8

Rock Star Ltd. discontinues a business segment. Under the agreement with employee's union, the employees of the discontinued segment will earn no further benefit. This is a curtailment without settlement, because employees will continue to receive benefits for

services rendered before discontinuance of the business segment. Curtailment reduces the gross obligation for various reasons including change in actuarial assumptions made before curtailment. If the benefits are determined based on the last pay drawn by employees, the gross obligation reduces after the curtailment because the last pay earlier assumed is no longer valid.

Rock Star Ltd. estimates the share of unamortized service cost that relates to the part of the obligation at ₹ 18 (10% of ₹ 180). Calculate the gain from curtailment and liability after curtailment to be recognised in the balance sheet of Rock Star Ltd. on the basis of given information:

- Immediately before the curtailment, gross obligation is estimated at ₹ 6,000 based on current actuarial assumption.
- The fair value of plan assets on the date is estimated at ₹ 5,100.
- The unamortized past service cost is ₹ 180.
- Curtailment reduces the obligation by ₹ 600, which is 10% of the gross obligation.

Solution 8

Gain from curtailment is estimated as under:

	₹
Reduction in gross obligation	600
Less: Proportion of unamortised past service cost	(18)
Gain from curtailment	<u>582</u>

The liability to be recognised after curtailment in the balance sheet is estimated as under:

	₹
Reduced gross obligation (90% of ₹ 6,000)	5,400
Less: Fair value of plan assets	(5,100)
	300
Less: Unamortised past service cost (90% of ₹ 180)	(162)
Liability to be recognised in the balance sheet	<u>138</u>

Illustration 9

An employee Roshan has joined a company XYZ Ltd. in the year 20X1. The annual emoluments of Roshan as decided is ₹ 14,90,210. The company also has a policy of giving a lump sum payment of 25% of the last drawn annual salary of the employee for each completed year of service if the employee retires after completing minimum 5 years of service. The salary of the Roshan is expected to grow @ 10% per annum.

The company has inducted Roshan in the beginning of the year and it is expected that he will complete the minimum five year term before retiring. Thus he will get 5 yearly increment.

What is the amount the company should charge in its Profit and Loss account every year as cost for the Defined Benefit obligation? Also calculate the current service cost and the interest cost to be charged per year assuming a discount rate of 8%.

(P.V factor for 8% - 0.735, 0.794, 0.857, 0.926, 1)

Solution 9

Calculation of Defined Benefit Obligation (DBO)

Expected last drawn salary = ₹ 14,90,210 × 110% × 110% × 110% × 110% × 110%
= ₹ 24,00,000

Defined Benefit Obligation (DBO) = ₹ 24,00,000 × 25% × 5 = ₹ 30,00,000

Amount of ₹ 6,00,000 will be charged to Profit and Loss Account of the company every year as cost for Defined Benefit Obligation.

Calculation of Current Service Cost

Year	Equal apportioned amount of DBO [i.e. ₹ 30,00,000/5 years]	Discounting @ 8% PV factor	Current service cost (Present Value)
a	b	c	d = b × c
1	6,00,000	0.735 (4 Years)	4,41,000
2	6,00,000	0.794 (3 Years)	4,76,400
3	6,00,000	0.857 (2 Years)	5,14,200
4	6,00,000	0.926 (1 Year)	5,55,600
5	6,00,000	1 (0 Year)	6,00,000

Calculation of Interest Cost to be charged per year

Year	Opening balance	Interest cost	Current service cost	Closing balance
a	b	c = b × 8%	d	e = b + c + d
1	0	0	4,41,000	4,41,000
2	4,41,000	35,280	4,76,400	9,52,680
3	9,52,680	76,214	5,14,200	15,43,094
4	15,43,094	1,23,447	5,55,600	22,22,141
5	22,22,141	1,77,859*	6,00,000	30,00,000

*Due to approximations used in calculation, this figure is adjusted accordingly.

MULTIPLE CHOICE QUESTIONS

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 post- employment benefits 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.	(c)	2.	(c)	3.	(b)	4.	(b)	5.	(c)
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THEORETICAL QUESTIONS

Question 6

What are the types of Employees benefits and what is the objective of Introduction of this Standard i.e. AS 15?

Solution 6

There are four types of employee benefits according to AS 15 (Revised 2005). They are:

- (a) short-term employee benefits, such as wages, salaries and social security contributions (e.g., contribution to an insurance company by an employer to pay for medical care of its employees), paid annual leave, profit-sharing and bonuses (if payable within twelve months of the end of the period) and non-monetary benefits (such as medical care, housing, cars and free or subsidised goods or services) for current employees;
- (b) post-employment benefits such as gratuity, pension, other retirement benefits, post-employment life insurance and post-employment medical care;
- (c) other long-term employee benefits, including long-service leave or sabbatical leave, jubilee or other long-service benefits, long-term disability benefits and, if they are not payable wholly within twelve months after the end of the period, profit-sharing, bonuses and deferred compensation; and
- (d) termination benefits.

Because each category identified in (a) to (d) above has different characteristics, this Statement establishes separate requirements for each category.

The objective of AS 15 is to prescribe the accounting and disclosure for employee benefits.

The statement requires an enterprise to recognise:

- (a) a liability when an employee has provided service in exchange for employee benefits to be paid in the future; and
- (b) an expense when the enterprise consumes the economic benefit arising from service provided by an employee in exchange for employee benefits.

PRACTICAL QUESTIONS

Question 7

A company has a scheme for payment of settlement allowance to retiring employees. Under the scheme, retiring employees are entitled to reimbursement of certain travel expenses for class they are entitled to as per company rule and to a lump-sum payment to cover expenses on food and stay during the travel. Alternatively, employees can claim a lump sum amount equal to one month pay last drawn.

The company's contentions in this matter are:

- (i) Settlement allowance does not depend upon the length of service of employee. It is restricted to employee's eligibility under the Travel rule of the company or where option for lump-sum payment is exercised, equal to the last pay drawn.
- (ii) Since it is not related to the length of service of the employees, it is accounted for on claim basis.

State whether the contentions of the company are correct as per relevant Accounting Standard. Give reasons in support of your answer.

Solution 7

The present case falls under the category of defined benefit scheme under Para 49 of AS 15 (Revised) "Employee Benefits". The said para encompasses cases where payment promised to be made to an employee at or near retirement presents significant difficulties in the determination of periodic charge to the statement of profit and loss. The contention of the Company that the settlement allowance will be accounted for on claim basis is not correct even if company's obligation under the scheme is uncertain and requires estimation. In estimating the obligation, assumptions may need to be made regarding future conditions and events, which are largely outside the company's control. Thus,

- (1) Settlement allowance payable by the company is a defined retirement benefit, covered by AS 15 (Revised).
- (2) A provision should be made every year in the accounts for the accruing liability on account of settlement allowance. The amount of provision should be calculated according to actuarial valuation.
- (3) Where, however, the amount of provision so determined is not material, the company can follow some other method of accounting for settlement allowances.

Question 8

The following data apply to 'X' Ltd. defined benefit pension plan for the year ended 31.03.20X2 calculate the actual return on plan assets:

- Benefits paid	2,00,000
- Employer contribution	2,80,000
- Fair market value of plan assets on 31.03.20X2	11,40,000
- Fair market value of plan assets as on 31.03.20X1	8,00,000

Solution 8

	₹
Fair value of plan assets on 31.3.20X1	8,00,000
Add: Employer contribution	2,80,000
Less: Benefits paid	(2,00,000)
(A)	<u>8,80,000</u>
Fair market value of plan assets at 31.3.20X2 (B)	<u>11,40,000</u>
Actual return on plan assets (B-A)	<u>2,60,000</u>

Question 9

The fair value of plan assets of Anupam Ltd. was ₹ 2,00,000 in respect of employee benefit pension plan as on 1st April, 20X1. On 30th September, 20X1 the plan paid out benefits of ₹ 25,000 and received inward contributions of ₹ 55,000. On 31st March, 20X2 the fair value of plan assets was ₹ 3,00,000. On 1st April, 20X1 the company made the following estimates, based on its market studies and prevailing prices.

	%
Interest and dividend income (after tax) payable by fund	10.25
Realized gains on plan assets (after tax)	3.00
Fund administrative costs	(3.00)
Expected rate of return	10.25

Calculate the expected and actual returns on plan assets as on 31st March, 20X2, as per AS 15.

Solution 9

Computation of Expected Returns on Plan Assets as on 31st March, 20X2, as per AS 15

	₹
Return on opening value of plan assets of ₹ 2,00,000 (held for the year) @ 10.25%	20,500
Add: Return on net gain of ₹ 30,000 (i.e. ₹ 55,000 – ₹ 25,000) during the year i.e. held for six months @ 5% (equivalent to 10.25% annually, compounded every six months)	1,500
Expected return on plan assets as on 31st March, 20X2	<u>22,000</u>

Computation of Actual Returns on Plan Assets as on 31st March, 20X2,
as per AS 15

	₹	₹
Fair value of Plan Assets as on 31st March, 20X2		3,00,000
Less: Fair value of Plan Assets as on 1st April, 20X1	(2,00,000)	
Add: Contribution received as on 30th September, 20X1	55,000	(2,55,000)
		45,000
Add: Benefits paid as on 30th September, 20X1		25,000
Actual returns on Plan Assets as on 31st March, 20X2		70,000

AS 25 - INTERIM FINANCIAL REPORTING

OBJECTIVE

The objective of this Standard is to prescribe the minimum content of an interim financial report and to prescribe the principles for recognition and measurement in a complete or condensed financial statements for an interim period.

SCOPE

1. This Statement does not mandate which enterprises should be required to present interim financial reports, how frequently, or how soon after the end of an interim period. If an enterprise is required or elects to prepare and present an interim financial report, it should comply with this Statement.
2. A statute governing an enterprise or a regulator may require an enterprise to prepare and present certain information at an interim date which may be different in form and/or content as required by this Statement. In such a case, the recognition and measurement principles as laid down in this Statement are applied in respect of such information, unless otherwise specified in the statute or by the regulator.
3. The requirements related to cash flow statement, complete or condensed, contained in this Statement are applicable where an enterprise prepares and presents a cash flow statement for the purpose of its annual financial report.

DEFINITIONS

The following terms are used in this Standard with the meanings specified:

- 1) Interim period is a financial reporting period shorter than a full financial year.
- 2) Interim financial report means a financial report containing either a complete set of financial statements or a set of condensed financial statements (as described in this Standard) for an interim period.

CONTENT OF AN INTERIM FINANCIAL REPORT

A complete set of financial statements normally includes:

- balance sheet;
- statement of profit and loss;
- cash flow statement; and
- notes including those relating to accounting policies and other statements and explanatory material that are an integral part of the financial statements.

FORM AND CONTENT OF INTERIM FINANCIAL STATEMENTS

- 1) If an enterprise prepares and presents a complete set of financial statements in its interim financial report, the form and content of those statements should conform to the requirements as applicable to annual complete set of financial statements.
- 2) If an enterprise prepares and presents a set of condensed financial statements in its interim financial report, those condensed statements should include, at a minimum, each of the headings and sub-headings that were included in its most recent annual financial statements and the selected explanatory notes as required by this Statement
- 3) If an enterprise presents basic and diluted earnings per share in its annual financial statements in accordance with Accounting Standard (AS) 20, Earnings Per Share, basic and diluted earnings per share should be presented in accordance with AS 20 on the face of the statement of profit and loss, complete or condensed, for an interim period.
- 4) If an enterprise's annual financial report included the consolidated financial statements in addition to the parent's separate financial statements, the interim financial report includes both the consolidated financial statements and separate financial statements, complete or condensed.

Explanatory Notes:

An enterprise should include the following information, as a minimum, in the notes to its interim financial statements, if material and if not disclosed elsewhere in the interim financial report:

- (a) a statement that the same accounting policies are followed in the interim financial statements as those followed in the most recent annual financial statements or, if those policies have been changed, a description of the nature and effect of the change;
- (b) explanatory comments about the seasonality of interim operations;
- (c) the nature and amount of items affecting assets, liabilities, equity, net income, or cash flows that are unusual because of their nature, size, or incidence.
- (d) the nature and amount of changes in estimates of amounts reported in prior interim

periods of the current financial year or changes in estimates of amounts reported in prior financial years, if those changes have a material effect in the current interim period;

- (e) issuances, buy-backs, repayments and restructuring of debt, equity and potential equity shares;
- (f) dividends, aggregate or per share (in absolute or percentage terms), separately for equity shares and other shares;
- (g) segment revenue, segment capital employed (segment assets minus segment liabilities) and segment result for business segments or geographical segments, whichever is the enterprise's primary basis of segment reporting (disclosure of segment information is required in an enterprise's interim financial report only if the enterprise is required, in terms of AS 17, Segment Reporting, to disclose segment information in its annual financial statements);
- (h) material events subsequent to the end of the interim period that have not been reflected in the financial statements for the interim period;
- (i) the effect of changes in the composition of the enterprise during the interim period, such as amalgamations, acquisition or disposal of subsidiaries and long-term investments, restructurings, and discontinuing operations; and
- (j) material changes in contingent liabilities since the last annual balance sheet date.

Periods for which Interim Financial Statements are required to be presented:

- 1) Interim reports should include interim financial statements (condensed or complete) for periods as follows:
 - balance sheet as of the end of the current interim period and a comparative balance sheet as of the end of the immediately preceding financial year;
 - statements of profit and loss for the current interim period and cumulatively for the current financial year to date, with comparative statements of profit and loss for the comparable interim periods (current and year-to-date) of the immediately preceding financial year;
 - cash flow statement cumulatively for the current financial year to date, with a comparative statement for the comparable year-to-date period of the immediately preceding financial year.
- 2) For an enterprise whose business is highly seasonal, financial information for the twelve months ending on the interim reporting date and comparative information for the prior twelve-month period may be useful.

MATERIALITY

In deciding how to recognize, measure, classify, or disclose an item for interim financial reporting purposes, materiality should be assessed in relation to the interim period financial data. In making assessments of materiality, it should be recognized that interim measurements may rely on estimates to a greater extent than measurements of annual financial.

DISCLOSURE

An enterprise may not prepare and present a separate financial report for the final interim period because the annual financial statements are presented.

If an estimate of an amount reported in an interim period is changed significantly during the final interim period of the financial year but a separate financial report is not prepared and presented for that final interim period, the nature and amount of that change in estimate should be disclosed in a note to the annual financial statements for that financial year.

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ILLUSTRATION QUESTION

Illustration 1

Sincere Corporation is dealing in seasonal product. Sales pattern of the product quarter-wise is as follows:

1st quarter 30th June	10%
2nd quarter 30th September	10%
3rd quarter 31st December	60%
4th quarter 31st March	20%

Information regarding the 1st quarter ended on 30th June, 20X1 is as follows:

Sales	80 crores
Salary and other expenses	60 crores
Advertisement expenses (routine)	4 crores
Administrative and selling expenses	8 crores

While preparing interim financial report for first quarter Sincere Corporation wants to defer ₹ 10 crores expenditure to third quarter on the argument that third quarter is having more sales, therefore, the third quarter should be debited by more expenditure. Considering the seasonal nature of business and the expenditures are uniform throughout all quarters, calculate the result of the first quarter as per AS 25. Also give a comment on the company's view.

Solution

Particulars	(₹ In crores)	
Result of first quarter ended 30th June, 20X1		
Turnover	80	
Other Income	Nil	
Total (a)		80
Less: Changes in inventories		Nil
Salaries and other cost		60
Administrative and selling Expenses (4+8)		12
Total (b)		72
Profit (a)-(b)		8

According to AS 25, the Income and Expense should be recognized when they are earned and incurred respectively. Therefore, seasonal incomes will be recognized when they occur. Thus, the company's view is not as per AS 25.

Illustration 2

The accounting year of X Ltd. ends on 30th September, 20X1 and it makes its reports quarterly. However for the purpose of tax, year ends on 31st March every year. For the Accounting year from 1-10-20X0 to 30-9-20X1, the quarterly income is as under:

1st quarter ending on 31st December, 20X0	₹ 200 crores
2nd quarter ending on 31st March, 20X1	₹ 200 crores
3rd quarter ending on 30th June, 20X1	₹ 200 crores
4th quarter ending on 30th September, 20X1	₹ 200 crores
Total	₹ 800 crores

Average actual tax rate for the financial year ending on 31st March, 20X1 is 20% and for financial year ending 31st March, 20X2 is 30%. Calculate tax expense for each quarter.

Solution

Calculation of tax expense

1st quarter ending on 31st December, 20X0	200 × 20%	₹ 40 lakhs
2nd quarter ending on 31st March, 20X1	200 × 20%	₹ 40 lakhs
3rd quarter ending on 30th June, 20X1	200 × 30%	₹ 60 lakhs
4th quarter ending on 30th September, 20X1	200 × 30%	₹ 60 lakhs

Illustration 3

Accountants of Poornima Ltd. showed a net profit of ₹ 7,20,000 for the third quarter of 20X1 after incorporating the following:

- Bad debts of ₹ 40,000 incurred during the quarter. 50% of the bad debts have been deferred to the next quarter.
- Extra ordinary loss of ₹ 35,000 incurred during the quarter has been fully recognized in this quarter.
- Additional depreciation of ₹ 45,000 resulting from the change in the method of charge of depreciation assuming that ₹ 45,000 is the charge for the 3rd quarter only.

Ascertain the correct quarterly income.

Solution

In the above case, the quarterly income has not been correctly stated. As per AS 25 “Interim Financial Reporting”, the quarterly income should be adjusted and restated as follows:

Bad debts of ₹ 40,000 have been incurred during current quarter. Out of this, the

company has deferred 50% (i.e.) ₹ 20,000 to the next quarter. Therefore, ₹ 20,000 should be deducted from ₹ 7,20,000. The treatment of extra-ordinary loss of ₹ 35,000 being recognized in the same quarter is correct.

Recognising additional depreciation of ₹ 45,000 in the same quarter is in tune with AS 25. Hence no adjustments are required for these two items.

Poornima Ltd should report quarterly income as ₹ 7,00,000 (₹ 7,20,000 – ₹ 20,000).

Illustration 4

Intelligent Corporation (I Corp.) is dealing in seasonal products. The quarterly sales pattern of the product is given below:

Quarter I	II	III	IV
Ending 30th June 15%	30th September 15%	31st December 50%	31st March 25%

For the First quarter ending 30th June, 20X1, I-Corp. gives you the following information:

	₹ crores
Sales	50
Salary and other expenses	30
Advertisement expenses (routine)	02
Administrative and selling expenses	08

While preparing interim financial report for the first quarter, 'I-Corp.' wants to defer ₹ 21 crores expenditure to third quarter on the argument that third quarter is having more sales, therefore, third quarter should be debited by higher expenditure, considering the seasonal nature of business and that the expenditures are uniform throughout all quarters.

Calculate the result of first quarter as per AS 25 and comment on the company's view.

Solution

Result of the first quarter ended 30th June, 20X1

	(₹ in crores)
Turnover	50
Add: Other Income	Nil
Total	50
Less: Change in inventories	Nil
Salaries and other cost	30
Administrative and selling expenses (8 + 2)	<u>10</u>
Profit	10

As per AS 25 on Interim Financial Reporting, the income and expense should be recognized when they are earned and incurred respectively. As per AS 25, the costs should be anticipated or deferred only when

- (i) it is appropriate to anticipate that type of cost at the end of the financial year, and
- (ii) costs are incurred unevenly during the financial year of an enterprise.

Therefore, the argument given by I-Corp relating to deferment of ₹ 21 crores is not tenable as expenditures are uniform throughout all quarters.

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MULTIPLE CHOICE QUESTIONS

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.	(d)	2.	(d)	3.	(a)	4.	(b)
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THEORETICAL QUESTIONS

Question 5

What are the periods for which Interim financial Statements are required to be presented? You are required to answer your question in light of preparation of financial statements for the period ended and as at 31st December, 20X1. The Financial Year is FY 20X1-X2.

Solution

As per Accounting Standard 25, Interim reports should include interim financial statements (condensed or complete) for periods as given below.

Statement	Current period	Comparative period
Balance sheet	End of current interim period	End of immediately preceding financial year
Statement of profit and loss	Current interim period and cumulatively for the year-to-date	Comparable interim period and year-to-date of immediately preceding financial year
Cash flow statement	Cumulatively for the current financial year- to-date	Comparable year-to-date of immediately preceding financial year

In light of the above, following periods needs to be covered in interim financial statements for the period ended and as at 31st December, 20X1:

Balance Sheet	as of the end of the current interim period and a comparative balance sheet as of the end of the immediately preceding financial year (As at 31 December 20X1 and 31 March 20X1).
Statements of Profit and Loss	for the current interim period and cumulatively for the current financial year to date, with comparative statements of profit and loss for the comparable interim periods (current and year-to-date) of the immediately preceding financial year. (for 3 months and 9 months i.e., year to date ended 31 December 20X1 and same for 31 December 20X0 being comparative period).
Cash Flow Statement	cumulatively for the current financial year to date, with a comparative statement for the comparable year-to-date period of the immediately preceding financial year. (year to date i.e., 1 April 20X1 to 31 December 20X1 and 1 April 20X0 to 31 December 20X0).

Question 6

Whether quarterly financial results presented under Clause 41 of the Listing Agreement entered into between Stock Exchanges and the listed enterprises meet the definition of 'interim financial report' as per AS 25 and the provisions of AS 25 should be applied on the same?

Solution

The presentation and disclosure requirements contained in AS 25 should be applied only if an enterprise prepares and presents an 'interim financial report' as defined in AS 25. Accordingly, presentation and disclosure requirements contained in AS 25 are not required to be applied in respect of interim financial results (which do not meet the definition of 'interim financial report' as per AS 25) presented by an enterprise.

The quarterly financial results presented under Clause 41 of the Listing Agreement do not meet the definition of 'interim financial report' as per AS 25. However, the recognition and measurement principles laid down in AS 25 should be applied for recognition and measurement of items contained in such interim financial results.

Question 7

Whether the impairment loss recognized on property, plant and equipment in first quarter of the financial year can be reversed in the second quarter in that financial year?

Solution

As per AS 25, the principles for recognising and measuring losses from inventory write-downs, restructurings, or impairments in an interim period are the same as those that an enterprise would follow if it prepared only annual financial statements. However, if such items are recognised and measured in one interim period and the estimate changes in a subsequent interim period of that financial year, the original estimate is changed in the subsequent interim period either by accrual of an additional amount of loss or by reversal of the previously recognised amount. In light of the same, the impairment loss recognized in one quarter can be reversed in the another quarter of the financial year, if favourable indicator exists as per AS 28 and the recoverable amount increased in comparison to earlier period.

PRACTICAL QUESTIONS

Question 8

In view of the provisions of Accounting Standard 25 on Interim Financial Reporting, on what basis will you calculate, for an interim period, the provision in respect of defined benefit schemes like pension, gratuity etc. for the employees?

Solution

Accounting Standard 25 suggests that provision in respect of defined benefit schemes like pension and gratuity for an interim period should be calculated based on the year-to-date basis by using the actuarially determined rates at the end of the prior financial year, adjusted for significant market fluctuations since that time and for significant curtailments, settlements or other significant one-time events.

Question 9

On 30th June, 20X1, Asmitha Ltd. incurred ₹ 2,00,000, net loss from disposal of a business segment. Also, on 31st July, 20X1, the company paid ₹ 60,000 for property taxes assessed for the calendar year 20X1. How the above transactions should be included in determination of net income of Asmitha Ltd. for the six months interim period ended on 30th September, 20X1.

Solution

According to Para 10 of AS 25 “Interim Financial Reporting”, if an enterprise prepares and presents a complete set of financial statements in its interim financial report, the form and content of those statements should conform to the requirements as applicable to annual complete set of financial statements. As at 30th September, 20X1, Asmitha Ltd would report the entire amount of ₹ 2,00,000 as loss on the disposal of its business segment since the loss was incurred during interim period. A cost charged as an expense in an annual period should be allocated to interim periods on accrual basis.

Since ₹ 60,000 Property tax payment relates to entire calendar year 20X1, ₹ 30,000 would be reported as an expense for six months ended on 30th September, 20X1 while out of the remaining ₹ 30,000, ₹ 15,000 for January, 20X1 to March, 20X1 should be shown as payment of the outstanding amount of previous year and another ₹ 15,000 related to quarter October, 20X1 to December, 20X1 would be reported as prepaid expenses.

Question 10

An enterprise reports quarterly, estimates an annual income of ₹ 10 lakhs. Assume tax rates on 1st ₹ 5,00,000 at 30% and on the balance income at 40%. The estimated quarterly income are ₹ 75,000, ₹ 2,50,000, ₹ 3,75,000 and ₹ 3,00,000.

Calculate the tax expense to be recognized in each quarter.

Solution

As per para 29 of AS 25 'Interim Financial Reporting', income tax expense is recognised in each interim period based on the best estimate of the weighted average annual income tax rate expected for the full financial year.

	₹
Estimated Annual Income (A)	10,00,000
Tax expense:	
30% on ₹ 5,00,000	1,50,000
40% on remaining ₹ 5,00,000	2,00,000
(B)	3,50,000

$$\text{Weighted average annual income tax rate} = \frac{B}{A} = \frac{3,50,000}{10,00,000} = 35\%$$

Tax expense to be recognized in each of the quarterly reports	₹
Quarter I - ₹ 75,000 × 35%	26,250
Quarter II - ₹ 2,50,000 × 35%	87,500
Quarter III - ₹ 3,75,000 × 35%	1,31,250
Quarter IV - ₹ 3,00,000 × 35%	1,05,000
₹ 10,00,000	3,50,000

Question 11

Antarbarti Limited reported a Profit Before Tax (PBT) of ₹ 4 lakhs for the third quarter ending 30-09-20X1. On enquiry you observe the following. Give the treatment required under AS 25:

- Dividend income of ₹ 4 lakhs received during the quarter has been recognized to the extent of ₹ 1 lakh only.
- 80% of sales promotion expenses ₹ 15 lakhs incurred in the third quarter has been deferred to the fourth quarter as the sales in the last quarter is high.
- In the third quarter, the company changed depreciation method from WDV to SLM, which resulted in excess depreciation of ₹ 12 lakhs. The entire amount has been debited in the

third quarter, though the share of the third quarter is only ₹ 3 lakhs.

- (iv) ₹ 2 lakhs extra-ordinary gain received in third quarter was allocated equally to the third and fourth quarter.
- (v) Cumulative loss resulting from change in method of inventory valuation was recognized in the third quarter of ₹ 3 lakhs. Out of this loss ₹ 1 lakh relates to previous quarters.
- (vi) Sale of investment in the first quarter resulted in a gain of ₹ 20 lakhs. The company had apportioned this equally to the four quarters.

Prepare the adjusted profit before tax for the third quarter.

Solution

As per para 36 of AS 25 “Interim Financial Reporting”, seasonal or occasional revenue and cost within a financial year should not be deferred as of interim date until it is appropriate to defer at the end of the enterprise’s financial year. Therefore, dividend income, extra-ordinary gain, and gain on sale of investment received during 3rd quarter should be recognised in the 3rd quarter only. Similarly, sales promotion expenses incurred in the 3rd quarter should also be charged in the 3rd quarter only.

Further, as per AS 10, Property, Plant and Equipment, if there is change in the depreciation method, such a change should be accounted for as a change in accounting estimate in accordance with AS 5, Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies, and applied prospectively. Therefore, no adjustment would be required due to change in the method of depreciation.

Accordingly, the adjusted profit before tax for the 3rd quarter will be as follows:

Statement showing Adjusted Profit Before Tax for the third quarter

	(₹ in lakhs)
Profit before tax (as reported)	4
Add: Dividend income ₹ (4 - 1) lakhs	3
Excess depreciation charged in the 3rd quarter, due to change in the method	-
Extra ordinary gain ₹ (2 - 1) lakhs	1
Cumulative loss due to change in the method of inventory valuation should be applied retrospectively ₹ (3 - 2) lakhs	1
	9

Less: Sales promotion expenses (80% of ₹ 15 lakhs)	(12)
Gain on sale of investment (occasional gain should not be deferred)	(5)
Adjusted Profit before tax for the third quarter	(8)

AS 28 - IMPAIRMENT OF ASSETS

Objective

The objective of this Standard is to prescribe the procedures that an enterprise applies to ensure that its assets are carried at no more than their recoverable amount. An asset is carried at more than its recoverable amount if its carrying amount exceeds the amount to be recovered through use or sale of the asset. If this is the case, the asset is described as impaired and this Standard requires the enterprise to recognize an impairment loss.

Scope

This Standard should be applied in accounting for the impairment of all assets, other than:

- inventories (see AS 2, Valuation of Inventories);
- assets arising from construction contracts (see AS 7, Construction Contracts);
- financial assets, including investments that are included in the scope of AS 13, Accounting for Investments; and
- deferred tax assets (see AS 22, Accounting for Taxes on Income).

Definitions

The following terms are used in this Standard with the meanings specified:

- 1) **Recoverable amount** is the higher of an asset's net selling price and its value in use.
- 2) **Value in use** is the present value of estimated future cash flows expected to arise from the continuing use of an asset and from its disposal at the end of its useful life.
- 3) **Net selling price** is the amount obtainable from the sale of an asset in an arm's length transaction between knowledgeable, willing parties, less the costs of disposal.
- 4) **Costs of disposal** are incremental costs directly attributable to the disposal of an asset, excluding finance costs and income tax expense.
- 5) **An impairment loss** is the amount by which the carrying amount of an asset exceeds its recoverable amount.
- 6) **Carrying amount** is the amount at which an asset is recognised in the balance sheet after deducting any accumulated depreciation (amortisation) and accumulated

impairment losses thereon.

- 7) **Depreciation (Amortisation)** is a systematic allocation of the depreciable amount of an asset over its useful life.
- 8) **Depreciable amount** is the cost of an asset, or other amount substituted for cost in the financial statements, less its residual value.
- 9) **Useful life is either:**
 - the period of time over which an asset is expected to be used by the enterprise; or
 - the number of production or similar units expected to be obtained from the asset by the enterprise.
- 10) **A cash-generating unit** is the smallest identifiable group of assets that generates cash inflows from continuing use that are largely independent of the cash inflows from other assets or groups of assets.
- 11) **Corporate assets** are assets other than goodwill that contribute to the future cash flows of both the cash generating unit under review and other cash generating units.
- 12) **An active market** is a market where all the following conditions exist :
 - the items traded within the market are homogeneous;
 - willing buyers and sellers can normally be found at any time; and
 - prices are available to the public.

Identifying an Asset that may be Impaired

An asset is impaired when the carrying amount of the asset exceeds its recoverable amount. These requirements use the term 'an asset' but apply equally to an individual asset or a cash-generating unit. An enterprise should assess at each balance sheet date whether there is any indication that an asset may be impaired. If any such indication exists, the enterprise should estimate the recoverable amount of the asset.

In assessing whether there is any indication that an asset may be impaired, an enterprise should consider, as a minimum, the following indications:

External sources of information

- (a) during the period, an 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 enterprise have taken place during the period, or will take place in the near future, in the technological, market, economic or legal environment in which the enterprise operates or in the market to

which an asset is dedicated;

- (c) market interest rates or other market rates of return on investments have increased during the period, and those increases are likely to affect the discount rate used in calculating an asset's value in use and decrease the asset's recoverable amount materially;
- (d) the carrying amount of the net assets of the reporting enterprise is more than its market capitalization;

Internal sources of information

- (e) evidence is available of obsolescence or physical damage of an asset;
- (f) significant changes with an adverse effect on the enterprise have taken place during the period, or are expected to take place in the near future, in the extent to which, or manner in which, an asset is used or is expected to be used. These changes include plans to discontinue or restructure the operation to which an asset belongs or to dispose of an asset before the previously expected date; and
- (g) evidence is available from internal reporting that indicates that the economic performance of an asset is, or will be, worse than expected.

Recognition and Measurement of an Impairment Loss

If the recoverable amount of an asset is less than its carrying amount, the carrying amount of the asset should be reduced to its recoverable amount. That reduction is an impairment loss.

An impairment loss should be recognised as an expense in the statement of profit and loss immediately, unless the asset is carried at revalued amount in accordance with another Accounting Standard (see Accounting Standard (AS) 10, Accounting for Fixed Assets), in which case any impairment loss of a revalued asset should be treated as a revaluation decrease under that Accounting Standard.

An impairment loss on a revalued asset is recognized as an expense in the statement of profit and loss. However, an impairment loss on a revalued asset is recognized directly against any revaluation surplus for the asset to the extent that the impairment loss does not exceed the amount held in the revaluation surplus for that same asset.

When the amount estimated for an impairment loss is greater than the carrying amount of the asset to which it relates, an enterprise should recognise a liability if, and only if, that is required by another Accounting Standard.

After the recognition of an impairment loss, the depreciation (amortization) charge for the asset should be adjusted in future periods to allocate the asset's revised carrying

amount, less its residual value (if any), on a systematic basis over its remaining useful life.

If an impairment loss is recognized, any related deferred tax assets or liabilities are determined under Accounting Standard (AS) 22, Accounting for Taxes on Income.

IDENTIFICATION OF THE CASH-GENERATING UNIT TO WHICH AN ASSET BELONGS

A cash generating unit is the smallest identifiable group of assets that generates cash inflows from continuing use that are largely independent of the cash inflows from other assets or groups of assets.

If there is any indication that an asset may be impaired, the recoverable amount should be estimated for the individual asset, if it is not possible to estimate the recoverable amount of the individual asset because the value in use of the asset cannot be determined and it is probably different from scrap value. Therefore, the enterprise estimates the recoverable amount of the cash-generating unit to which the asset belongs.

If recoverable amount cannot be determined for an individual asset, an enterprise identifies the lowest aggregation of assets that generate largely independent cash inflows from continuing use. Even if part or all of the output produced by an asset or a group of assets is used by other units of the reporting enterprise, this asset or group of assets forms a separate cash-generating unit if the enterprise could sell this output in an active market. This is because this asset or group of assets could generate cash inflows from continuing use that would be largely independent of the cash inflows from other assets or groups of assets.

In using information based on financial budgets/forecasts that relates to such a cash-generating unit, an enterprise adjusts this information if internal transfer prices do not reflect management's best estimate of future market prices for the cash-generating unit's output.

Cash-generating units should be identified consistently from period to period for the same asset or types of assets, unless a change is justified.

Example 1

A mining enterprise owns a private railway to support its mining activities. The

private railway could be sold only for scrap value and the private railway does not generate cash inflows from continuing use that are largely independent of the cash inflows from the other assets of the mine.

It is not possible to estimate the recoverable amount of the private railway because the value in use of the private railway cannot be determined and it is probably different from scrap value. Therefore, the enterprise estimates the recoverable amount of the cash-generating unit to which the private railway belongs, that is, the mine as a whole.

Example 2

A bus company provides services under contract with a municipality that requires minimum service on each of five separate routes. Assets devoted to each route and the cash flows from each route can be identified separately. One of the routes operates at a significant loss.

Since the enterprise does not have the option to curtail any one bus route, the lowest level of identifiable cash inflows from continuing use that are largely independent of the cash inflows from other assets or groups of assets is the cash inflows generated by the five routes together. The cash-generating unit for each route is the bus company as a whole.

If an active market exists for the output produced by an asset or a group of assets, this asset or group of assets should be identified as a separate cash-generating unit, even if some or all of the output is used internally.

Example 3

A machine has suffered physical damage but is still working, although not as well as it used to. The net selling price of the machine is less than its carrying amount.

The machine does not generate independent cash inflows from continuing use.

The smallest identifiable group of assets that includes the machine and generates cash inflows from continuing use that are largely independent of the cash inflows from other assets is the production line to which the machine belongs. The recoverable amount of the production line shows that the production line taken as a whole is not impaired.

Assumption 1: Budgets/forecasts approved by management reflect no commitment of

management to replace the machine.

The recoverable amount of the machine alone cannot be estimated since the machine's value in use:

- (a) may differ from its net selling price; and
- (b) can be determined only for the cash-generating unit to which the machine belongs (the production line).

The production line is not impaired, therefore, no impairment loss is recognised for the machine. Nevertheless, the enterprise may need to reassess the depreciation period or the depreciation method for the machine. Perhaps, a shorter depreciation period or a faster depreciation method is required to reflect the expected remaining useful life of the machine or the pattern in which economic benefits are consumed by the enterprise.

Assumption 2: Budgets/forecasts approved by management reflect a commitment of management to replace the machine and sell it in the near future.

Cash flows from continuing use of the machine until its disposal are estimated to be negligible.

The machine's value in use can be estimated to be close to its net selling price. Therefore, the recoverable amount of the machine can be determined and no consideration is given to the cash-generating unit to which the machine belongs (the production line). Since the machine's net selling price is less than its carrying amount, an impairment loss is recognised for the machine.

RECOVERABLE AMOUNT AND CARRYING AMOUNT OF A CASH-GENERATING UNIT

The carrying amount of a cash-generating unit should be determined consistently with the way the recoverable amount of the cash-generating unit is determined i.e., carrying amount is the summation of the carrying amount of all the assets grouped under one cash-generating unit. This also includes the liability only if that liability is necessary to be considered to determine the recovery amount. This may occur if the disposal of a cash-generating unit would require the buyer to take over a liability. In this case, the net selling price of the cash-generating unit is the estimated selling price for the assets of the cash-generating unit and the liability together, less the costs of disposal. In order to perform a meaningful comparison between the carrying amount of the cash-generating

unit and its recoverable amount, the carrying amount of the liability is deducted in determining both the cash-generating unit's value in use and its carrying amount.

For practical reasons, the recoverable amount of a cash-generating unit is sometimes determined after consideration of assets that are not part of the cash-generating unit or liabilities that have already been recognised in the financial statements. In such cases, the carrying amount of the cash-generating unit is increased by the carrying amount of those assets and decreased by the carrying amount of those liabilities.

GOODWILL

Goodwill does not generate cash flows independently from other assets or groups of assets and, therefore, the recoverable amount of goodwill as an individual asset cannot be determined. As a consequence, if there is an indication that goodwill may be impaired, recoverable amount is determined for the cash-generating unit to which goodwill belongs.

This amount is then compared to the carrying amount of this cash-generating unit and any impairment loss is recognized.

If goodwill can be allocated on a reasonable and consistent basis, an enterprise applies the 'bottom-up' test only. If it is not possible to allocate goodwill on a reasonable and consistent basis, an enterprise applies both the 'bottom-up' test and 'top-down' test.

IMPAIRMENT LOSS FOR A CASH-GENERATING UNIT (including Goodwill)

The impairment loss should be allocated to reduce the carrying amount of the assets of the unit in the following order:

- a. First, to goodwill allocated to the cash-generating unit (if any); and
- b. Then, to the other assets of the unit on a pro-rata basis based on the carrying amount of each asset in the unit.

These reductions in carrying amounts should be treated as impairment losses on individual assets

The carrying amount of an asset should not be reduced below the highest of:

- a. Its net selling price (if determinable);

- b. Its value in use (if determinable); and
- C. Zero.

The amount of the impairment loss that would otherwise have been allocated to the asset should be allocated to the other assets of the unit on a pro-rata basis.

After the requirements of impairment loss have been applied, a liability should be recognised for any remaining amount of an impairment loss for a cash-generating unit if that is required by another Accounting Standard.

CORPORATE ASSETS

Key characteristics of corporate assets are that they do not generate cash inflows independently from other assets or groups of assets and their carrying amount cannot be fully attributed to the cash-generating unit under review.

Examples- Building of a headquarter or a division of the enterprise, EDP equipment or a research Centre.

In testing a cash-generating unit for impairment, an enterprise should identify all the corporate assets that relate to the cash-generating unit under review.

For each identified corporate asset:

- a. If the carrying amount of the corporate asset can be allocated on a reasonable and consistent basis to the cash-generating unit under review, an enterprise should apply the 'bottom-up' test only; and
- b. If the carrying amount of the corporate asset cannot be allocated on a reasonable and consistent basis to the cash-generating unit under review, an enterprise should apply both the 'bottom-up' and 'top-down' tests.

REVERSAL OF AN IMPAIRMENT LOSS

An enterprise should assess at each balance sheet date whether there is any indication that an impairment loss recognised for an asset in prior accounting periods may no longer exist or may have decreased. If any such indication exists, the enterprise should

estimate the recoverable amount of that asset.

An impairment loss recognised for an asset in prior accounting periods should be reversed if there has been a change in the estimates of cash inflows, cash outflows or discount rates used to determine the asset's recoverable amount since the last impairment loss was recognised. If this is the case, the carrying amount of the asset should be increased to its recoverable amount. That increase is a reversal of an impairment loss.

REVERSAL OF AN IMPAIRMENT LOSS FOR AN INDIVIDUAL ASSET

Case I:

If impairment loss was written off to profit and loss account, then the reversal of impairment loss should be recognized as income in the financial statement immediately.

Case II:

If impairment loss was adjusted with the Revaluation Reserve; then reversal of impairment loss will be written back to the reserve account to the extent it was adjusted, any surplus will be recognised as revenue. But in any case the increased carrying amount of an asset due to a reversal of an impairment loss should not exceed the carrying amount that would have been determined (net of amortisation or depreciation) had no impairment loss been recognised for the asset in prior accounting periods. This is mainly because any further increase in value of asset is revaluation, which is governed by AS 10.

Depreciation impact post reversal of impairment loss:

After a reversal of an impairment loss is recognised, the depreciation(amortisation) charge for the asset should be adjusted in future periods to allocate the asset's revised carrying amount, less its residual value (if any), on a systematic basis over its remaining useful life.

REVERSAL OF AN IMPAIRMENT LOSS FOR A CASH-GENERATING UNIT

A reversal of an impairment loss for a cash-generating unit should be allocated to increase the carrying amount of the assets of the unit in the following order:

- a. First, assets other than goodwill on a pro-rata basis based on the carrying amount of each asset in the unit; and

b. Then, to goodwill allocated to the cash-generating unit (if any),

In allocating a reversal of an impairment loss for a cash generating unit under paragraph 106, the carrying amount of an asset should not be increased above the lower of:

- (a) its recoverable amount (if determinable); and
- (b) the carrying amount that would have been determined (net of amortisation or depreciation) had no impairment loss been recognised for the asset in prior accounting periods.

The amount of the reversal of the impairment loss that would otherwise have been allocated to the asset should be allocated to the other assets of the unit on a pro-rata basis.

REVERSAL OF AN IMPAIRMENT LOSS FOR GOODWILL

This Statement does not permit an impairment loss to be reversed for goodwill because of a change in estimates (for example, a change in the discount rate or in the amount and timing of future cash flows of the cash generating unit to which goodwill relates), an impairment loss recognised for goodwill should not be reversed in a subsequent period unless:

- a. The impairment loss was caused by a specific external event of an exceptional nature that is not expected to recur; and
- b. Subsequent external events have occurred that reverse the effect of that event.

IMPAIRMENT IN CASE OF DISCONTINUING OPERATIONS

The approval and announcement of a plan for discontinuance is an indication that the assets attributable to the discontinuing operation may be impaired or that an impairment loss previously recognised for those assets should be increased or reversed.

In applying this Statement to a discontinuing operation, an enterprise determines whether the recoverable amount of an asset of a discontinuing operation is assessed for the individual asset or for the asset's cash-generating unit.

For example:

- a. If the enterprise sells the discontinuing operation substantially in its entirety, none of the assets of the discontinuing operation generate cash inflows independently from other assets within the discontinuing operation.
Therefore, recoverable amount is determined for the discontinuing operation as a whole and an impairment loss, if any, is allocated among the assets of the discontinuing operation in accordance with this Statement;
- b. If the enterprise disposes of the discontinuing operation in other ways such as piecemeal sales, the recoverable amount is determined for individual assets, unless the assets are sold in groups; and
- c. If the enterprise abandons the discontinuing operation, the recoverable amount is determined for individual assets as set out in this Statement.

After announcement of a plan, negotiations with potential purchasers of the discontinuing operation or actual binding sale agreements may indicate that the assets of the discontinuing operation may be further impaired or that impairment losses recognised for these assets in prior periods may have decreased.

ILLUSTRATION QUESTION

Illustration 1

Ergo Industries Ltd. gives the following estimates of cash flows relating to Property, Plant and Equipment on 31-12-20X1. The discount rate is 15%.

Year	Cash Flow (₹ in lakhs)
20X2	4000
20X3	6000
20X4	6000
20X5	8000
20X6	4000
Residual value at the end of 20X6	= ₹ 1000 lakhs
Property, Plant and Equipment purchased on 1-1-20XX	= ₹ 40,000 lakhs
Useful life	= 8 years
Net selling price on 31-12-20X1	= ₹ 20,000 lakhs

Calculate on 31-12-20X1:

- Carrying amount at the end of 20X1
- Value in use on 31-12-20X1
- Recoverable amount on 31-12-20X1
- Impairment loss to be recognized for the year ended 31-12-20X1
- Revised carrying amount
- Depreciation charge for 20X2.

Note: The year 20XX is the immediate preceding year before the year 20X0.

Solution 1

Calculation of value in use

Year	Cash Flow	Discount as per 15%	Discounted cash flow
20X2	4,000	0.870	3,480
20X3	6,000	0.756	4,536
20X4	6,000	0.658	3,948
20X5	8,000	0.572	4,576

20X6	4,000	0.497	1,988
20X6	(residual) 1,000	0.497	<u>497</u>
			<u>19,025</u>

(a) Calculation of carrying amount:

Original cost = ₹ 40,000 lakhs

Depreciation for 3 years = $[(40,000 - 1000) \times 3/8] = ₹ 14,625$ lakhs

Carrying amount on 31-12-20X1 = $[40,000 - 14,625] = ₹ 25,375$ lakhs

(b) Value in use = ₹ 19,025 lakhs

(c) Recoverable amount = higher of value in use and net selling price i.e. ₹ 20,000 lakhs.

Recoverable amount = ₹ 20,000 lakhs

(d) Impairment Loss = ₹ (25,375 - 20,000) = ₹ 5,375 lakhs

(e) Revised carrying amount = ₹ (25,375 - 5,375) = ₹ 20,000 lakhs

(f) Depreciation charge for 20X2 = $(20,000 - 1000)/5 = ₹ 3,800$ lakhs

Illustration 2

X Ltd. is having a plant (asset) carrying amount of which is ₹ 100 lakhs on 31.3.20X1. Its balance useful life is 5 years and residual value at the end of 5 years is ₹ 5 lakhs. Estimated future cash flow from using the plant in next 5 years are:

For the year ended on	Estimated cash flow (₹ in lakhs)
31.3.20X2	50
31.3.20X3	30
31.3.20X4	30
31.3.20X5	20
31.3.20X6	20

Calculate “value in use” for plant if the discount rate is 10% and also calculate the recoverable amount if net selling price of plant on 31.3.20X1 is ₹ 60 lakhs.

Solution 2

Present value of future cash flow

Year ended	Future Cash Flow	Discount @ 10% Rate	Discounted cash flow
31.3.20X2	50	0.909	45.45
31.3.20X3	30	0.826	24.78
31.3.20X4	30	0.751	22.53
31.3.20X5	20	0.683	13.66

31.3.20X6	20	0.620	<u>12.40</u>
			118.82
Present value of residual price on 31.3.20X6 = 5 × 0.620			<u>3.10</u>
Present value of estimated cash flow by use of an asset and residual value, which is called “value in use”.			<u>121.92</u>

If net selling price of plant on 31.3.20X1 is ₹ 60 lakhs, the recoverable amount will be higher of ₹ 121.92 lakhs (value in use) and ₹ 60 lakhs (net selling price), hence recoverable amount is ₹ 121.92 lakhs.

Illustration 3

G Ltd., acquired a machine on 1st April, 20X0 for ₹ 7 crore that had an estimated useful life of 7 years. The machine is depreciated on straight line basis and does not carry any residual value. On 1st April, 20X4, the carrying value of the machine was reassessed at ₹ 5.10 crore and the surplus arising out of the revaluation being credited to revaluation reserve. For the year ended March, 20X6, conditions indicating an impairment of the machine existed and the amount recoverable ascertained to be only ₹ 79 lakhs. You are required to calculate the loss on impairment of the machine and show how this loss is to be treated in the books of G Ltd. G Ltd., had followed the policy of writing down the revaluation surplus by the increased charge of depreciation resulting from the revaluation.

Solution 3

Statement Showing Impairment Loss

	(` in crores)
Carrying amount of the machine as on 1st April, 20X0	7.00
Depreciation for 4 years i.e. 20X0-20X1 to 20X3-20X4	
$\left[\frac{7 \text{ Crores}}{7 \text{ Years}} \times 4 \text{ Years} \right]$	(4.00)
Carrying amount as on 31.03.20X4	3.00
Add: Upward Revaluation (credited to Revaluation Reserve account)	<u>2.10</u>
Carrying amount of the machine as on 1st April, 20X4 (revalued)	5.10
Less: Depreciation for 2 years i.e. 20X4-20X5 & 20X5-20X6	
$\left[\frac{5.10 \text{ Crores}}{3 \text{ Years}} \times 2 \text{ Years} \right]$	(3.40)

Carrying amount as on 31.03.20X6	1.70
Less: Recoverable amount	(0.79)
Impairment loss	0.91
Less: Balance in revaluation reserve as on 31.03.20X6:	
Balance in revaluation reserve as on 31.03.20X4	2.10
Less: Enhanced depreciation met from revaluation reserve	
20X4-20X5 & 20X5-20X6=[(1.70 – 1.00) × 2 years]	(1.40)
Impairment loss set off against revaluation reserve balance as per para	
58 of AS 28 “Impairment of Assets”	(0.70)
Impairment Loss to be debited to profit and loss account	0.21

Illustration 4

X Ltd. purchased a Property, Plant and Equipment four years ago for ₹ 150 lakhs and depreciates it at 10% p.a. on straight line method. At the end of the fourth year, it has revalued the asset at ₹ 75 lakhs and has written off the loss on revaluation to the profit and loss account. However, on the date of revaluation, the market price is ₹67.50 lakhs and expected disposal costs are ₹ 3 lakhs. What will be the treatment in respect of impairment loss on the basis that fair value for revaluation purpose is determined by market value and the value in use is estimated at ₹ 60 lakhs?

Solution 4

Treatment of Impairment Loss

As per para 57 of AS 28 “Impairment of assets”, if the recoverable amount (higher of net selling price and its value in use) of an asset is less than its carrying amount, the carrying amount of the asset should be reduced to its recoverable amount. In the given case, net selling price is ₹ 64.50 lakhs (₹ 67.50 lakhs – ₹ 3 lakhs) and value in use is ₹ 60 lakhs. Therefore, recoverable amount will be ₹ 64.50 lakhs. Impairment loss will be calculated as ₹ 10.50 lakhs [₹ 75 lakhs (Carrying Amount after revaluation – Refer Working Note) less ₹ 64.50 lakhs (Recoverable Amount)].

Thus impairment loss of ₹ 10.50 lakhs should be recognised as an expense in the Statement of Profit and Loss immediately since there was downward revaluation of asset which was already charged to Statement of Profit and Loss.

Working Note:

Calculation of carrying amount of the Property, Plant and Equipment at the end of the fourth year on revaluation

	(` in lakhs)
Purchase price of a Property, Plant and Equipment	150.00
Less: Depreciation for four years $[(150 \text{ lakhs} / 10 \text{ years}) \times 4 \text{ years}]$	(60.00)
Carrying value at the end of fourth year	90.00
Less: Downward revaluation charged to profit and loss account	(15.00)
Revalued carrying amount	75.00

Reference: The students are advised to refer the full text of AS 28 “Impairment of Assets” (issued 2002).

MULTIPLE CHOICE QUESTIONS

- 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:
 - No further action is required and the company can continue the asset in the books at the book value itself.
 - The entity should review the remaining useful life, scrap value and method of depreciation and amortization for the purposes of AS 10.
 - The entity can follow either (a) or (b).
 - The entity should review the scrap value and method of depreciation and amortization for the purposes of AS 10.
- In case Goodwill appears in the Balance Sheet of an entity, the following is true:
 - Apply Bottom up test if goodwill cannot be allocated to CGU (cash generating unit) under review.
 - Apply Top down test if goodwill cannot be allocated to CGU (cash generating unit) under review.
 - Apply both Bottom up test and Top down test if goodwill cannot be allocated to CGU (cash generating unit) under review.
 - Apply either Bottom up test or Top down test if goodwill cannot be allocated to CGU (cash generating unit) under review.
- In case of Corporate assets in the Balance Sheet of an entity, the following is true:
 - 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.	(b)	2.	(c)	3.	(c)	4.	(c)
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THEORETICAL QUESTIONS

Question 5

Write short note on impairment of asset and its application to inventory.

Solution 5

The objective of AS 28 'Impairment of Assets' is to prescribe the procedures that an enterprise applies to ensure that its assets are carried at no more than their recoverable amount. An asset is carried at more than its recoverable amount if its carrying amount exceeds the amount to be recovered through use or sale of the asset. If this is the case, the asset is described as impaired and this Standard requires the enterprise to recognize an impairment loss.

- If carrying amount $\leq$ Recoverable amount : Asset is not impaired
- If carrying amount $>$ Recoverable amount : Asset is impaired

Impairment Loss = Carrying Amount – Recoverable Amount

Recoverable amount is the higher of net selling price and its value in use

This standard should be applied in accounting for the impairment of all assets, other than (i) inventories (AS 2, Valuation of Inventories); (ii) assets arising from construction contracts (AS 7, Accounting for Construction Contracts); (iii) financial assets, including investments that are included in the scope of AS 13, Accounting for Investments; and (iv) deferred tax assets (AS 22, Accounting for Taxes on Income). AS 28 does not apply to inventories, assets arising from construction contracts, deferred tax assets or investments because other accounting standards applicable to these assets already contain specific requirements for recognizing and measuring the impairment related to these assets.

PRACTICAL QUESTIONS

Question 6

A publisher owns 150 magazine titles of which 70 were purchased and 80 were self-created. The price paid for a purchased magazine title is recognized as an intangible asset. The costs of creating magazine titles and maintaining the existing titles are recognized as an expense when incurred. Cash inflows from direct sales and advertising are identifiable for each magazine title. Titles are managed by customer segments. The level of advertising income for a magazine title depends on the range of titles in the customer segment to which the magazine title relates. Management has a policy to abandon old titles before the end of their economic lives and replace them immediately with new titles for the same customer segment. What is the cash-generating unit for an individual magazine title?

Solution 6

It is likely that the recoverable amount of an individual magazine title can be assessed. Even though the level of advertising income for a title is influenced, to a certain extent, by the other titles in the customer segment, cash inflows from direct sales and advertising are identifiable for each title. In addition, although titles are managed by customer segments, decisions to abandon titles are made on an individual title basis. Therefore, it is likely that individual magazine titles generate cash inflows that are largely independent of each other and that each magazine title is a separate cash-generating unit.

Question 7

An asset does not meet the requirements of environment laws which have been recently enacted. The asset has to be destroyed as per the law. The asset is carried in the Balance Sheet at the year end at ₹ 6,00,000. The estimated cost of destroying the asset is ₹ 70,000. How is the asset to be accounted for?

Solution 7

As per AS 28 “Impairment of Assets”, impairment loss is the amount by which the carrying amount of an asset exceeds its recoverable amount, where recoverable amount is the higher of an asset’s net selling price* and its value in use*. In the given case, recoverable amount will be nil [higher of value in use (nil) and net selling price (negative ₹ 70,000)]. Thus impairment loss will be calculated as ₹ 6,00,000 [carrying amount (₹ 6,00,000) – recoverable amount (nil)]. Therefore, asset is to be fully impaired and impairment loss

of ₹ 6,00,000 has to be recognized as an expense immediately in the statement of Profit and Loss as per para 58 of AS 28.

Further, as per para 60 of AS 28, When the amount estimated for an impairment loss is greater than the carrying amount of the asset to which it relates, an enterprise should recognise a liability if, and only if, that is required by another Accounting Standard. Hence, the entity should recognize liability for cost of disposal of ₹ 70,000 as per AS 10 & 29.

Question 8

Venus Ltd. has a fixed asset, which is carried in the Balance Sheet on 31.3.20X1 at ₹ 500 lakhs. As at that date the value in use is ₹ 400 lakhs and the net selling price is ₹ 375 lakhs. From the above data:

- Calculate impairment loss.
- Prepare journal entries for adjustment of impairment loss.
- Show, how impairment loss will be shown in the Balance Sheet.

Solution 8

- Recoverable amount is higher of value in use ₹ 400 lakhs and net selling price ₹ 375 lakhs.

Recoverable amount = ₹ 400 lakhs

Impairment loss = Carried Amount – Recoverable amount

= ₹ 500 lakhs – ₹ 400 lakhs = ₹ 100 lakhs.

	Particulars	Dr. Amount (₹ in lakhs)	Cr. Amount (₹ in lakhs)
(i)	Impairment loss account Dr. To Provision for Accumulated Impairment Loss Account (Being the entry for accounting impairment loss)	100	100
(ii)	Profit and loss account Dr. To Impairment loss (Being the entry to transfer impairment loss to profit and loss account)	100	100

(iii) Balance Sheet of Venus Ltd. as on 31.3.20X1

	(₹ in lakhs)
Fixed Asset	
Asset less depreciation	500
Less: Impairment loss	(100)
	400

Question 9

Good Drugs and Pharmaceuticals Ltd. acquired a sachet filling machine on 1st April, 20X1 for ₹ 60 lakhs. The machine was expected to have a productive life of 6 years. At the end of financial year 20X1-20X2 the carrying amount was ₹ 41 lakhs. A short circuit occurred in this financial year but luckily the machine did not get badly damaged and was still in working order at the close of the financial year. The machine was expected to fetch ₹ 36 lakhs, if sold in the market. The machine by itself is not capable of generating cash flows. However, the smallest group of assets comprising of this machine also, is capable of generating cash flows of ₹ 54 crore per annum and has a carrying amount of ₹ 3.46 crore. All such machines put together could fetch a sum of ₹ 4.44 crore if disposed. Discuss the applicability of Impairment loss.

Solution 9

As per provisions of AS 28 “Impairment of Assets”, impairment loss is not to be recognized for a given asset if its cash generating unit (CGU) is not impaired. In the given question, the related cash generating unit which is group of asset to which the damaged machine belongs is not impaired; and the recoverable amount is more than the carrying amount of group of assets. Hence there is no need to provide for impairment loss on the damaged sachet filling machine.

Question 10

From the following details of an asset

- (i) Find out impairment loss
- (ii) Treatment of impairment loss
- (iii) Current year depreciation

Particulars of asset:

Cost of asset	₹ 56 lakhs
Useful life period	10 years

Salvage value	Nil
Current carrying value	₹ 27.30 lakhs
Useful life remaining	3 years
Recoverable amount	₹ 12 lakhs
Upward revaluation done in last year	₹ 14 lakhs

Solution 10

According to AS 28 “Impairment of Assets”, an impairment loss on a revalued asset is recognised as an expense in the statement of profit and loss. However, an impairment loss on a revalued asset is recognised directly against any revaluation surplus for the asset to the extent that the impairment loss does not exceed the amount held in the revaluation surplus for that same asset.

Impairment Loss and its treatment	₹
Current carrying amount (including revaluation amount of ₹ 14 lakhs)	27,30,000
Less: Current recoverable amount	(12,00,000)
Impairment Loss	15,30,000
Impairment loss charged to revaluation reserve	14,00,000
Impairment loss charged to profit and loss account	1,30,000

After the recognition of an impairment loss, the depreciation (amortization) charge for the asset should be adjusted in future periods to allocate the asset's revised carrying amount, less its residual value (if any), on a systematic basis over its remaining useful life.

In the given case, the carrying amount of the asset will be reduced to ₹ 12,00,000 after impairment. This amount is required to be depreciated over remaining useful life of 3 years (including current year). Therefore, the depreciation for the current year will be ₹ 4,00,000.

Question 11

A plant was acquired 15 years ago at a cost of ₹ 5 crores. Its accumulated depreciation as at 31st March, 20X1 was ₹ 4.15 crores. Depreciation estimated for the financial year 20X1-20X2 is ₹ 25 lakhs. Estimated Net Selling Price as on 31st March, 20X1 was ₹ 30 lakhs, which is expected to decline by 20 per cent by the end of the next financial year.

Its value in use has been computed at ₹ 35 lakhs as on 1st April, 20X1, which is expected to decrease by 30 per cent by the end of the financial year.

- (i) Assuming that other conditions for applicability of the impairment Accounting Standard are satisfied, what should be the carrying amount of this plant as at 31st March, 20X2?

- (ii) How much will be the amount of write off for the financial year ended 31st March, 20X2?
- (iii) If the plant had been revalued ten years ago and the current revaluation reserves against this plant were to be ₹ 12 lakhs, how would you answer to questions (i) and (ii) above?
- (iv) If the value in use was zero and the enterprise were required to incur a cost of ₹ 2 lakhs to dispose of the plant, what would be your response to questions (i) and (ii) above?

Solution 11

As per AS 28 “Impairment of Assets”, if the recoverable amount* of an asset is less than its carrying amount, the carrying amount of the asset should be reduced to its recoverable amount and that reduction is an impairment loss. An impairment loss on a revalued asset is recognized as an expense in the statement of profit and loss. However, an impairment loss on a revalued asset is recognised directly against any revaluation surplus for the asset to the extent that the impairment loss does not exceed the amount held in the revaluation surplus for that same asset.

In the given case, recoverable amount (higher of asset’s net selling price and value in use) will be ₹ 24.5 lakhs on 31.3.20X2 according to the provisions of AS 28 [Refer working note].

	(₹ in lakhs)
(i) Carrying amount of plant (after impairment) as on 31st March, 20X2	24.50
(ii) Amount of write off (impairment loss) for the financial year ended 31st March, 20X2 [₹ 60 lakhs – ₹ 24.5 lakhs]	35.50
(iii) If the plant had been revalued ten years ago	
Debit to revaluation reserve	12.00
Amount charged to profit and loss account	23.50
(₹ 35.50 lakhs – ₹ 12 lakhs)	
(iv) If Value in use is zero	
Value in use (a)	Nil
Net selling price (b)	(-)2.00
Recoverable amount [higher of (a) and (b)]	Nil
Carrying amount (closing book value)	Nil
Amount of write off (impairment loss) (₹ 60 lakhs – Nil)	60.00
Entire book value of plant will be written off and charged to profit and loss account.	

Working Note:

Calculation of Closing Book Value, Estimated Net Selling Value and Estimated Value in Use of Plant at 31st March, 20X2

	(₹ in lakhs)
Opening book value as on 1.4.20X1 (₹ 500 lakhs – ₹415 lakhs)	85
Less: Depreciation for financial year 20X1–20X2	<u>(25)</u>
Closing book value as on 31.3.20X2	<u>60</u>
Estimated net selling price as on 1.4.20X1	30
Less: Estimated decrease during the year (20% of ₹ 30 lakhs)	<u>(6)</u>
Estimated net selling price as on 31.3.20X2	<u>24</u>
Estimated value in use as on 1.4.20X1	35.0
Less: Estimated decrease during the year (30% of ₹ 35 lakhs)	<u>(10.5)</u>
Estimated value in use as on 31.3.20X2	<u>24.5</u>