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P1: ADVANCED ACCOUNTING (MODULE – 2)

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6. LIABILITIES BASED ACCOUNTING STANDARDS

UNIT 1: ACCOUNTING STANDARD 15 EMPLOYEE BENEFITS

LEARNING OUTCOMES

After studying this unit, you will be able to

- Define 'Employee benefits', 'Short-term employee benefits', 'Postemployment benefits' and other related terms used in the Standard
- Enumerate various types of employee benefits
- Recognise and measure Short-term Employee Benefits, Short-term Compensated Absences and Profit-sharing and Bonus Plans along with the accounting thereof
- Classify the post-employment benefits into defined contribution plans and defined benefit plans
- Examine the various aspects inherent in these post-employment benefit plans and recognize and measure the obligations under these plans
- Apply the actuarial valuation methods and assumptions while valuing the obligations under Defined benefit plans
- Calculate the actuarial gains and losses on such plans
- Recognise gains or losses on the curtailment or settlement of a defined benefit plan
- Recognise and measure other long-term benefit and termination benefits
- Understand the disclosure requirement of these employee benefits and comply with the same.

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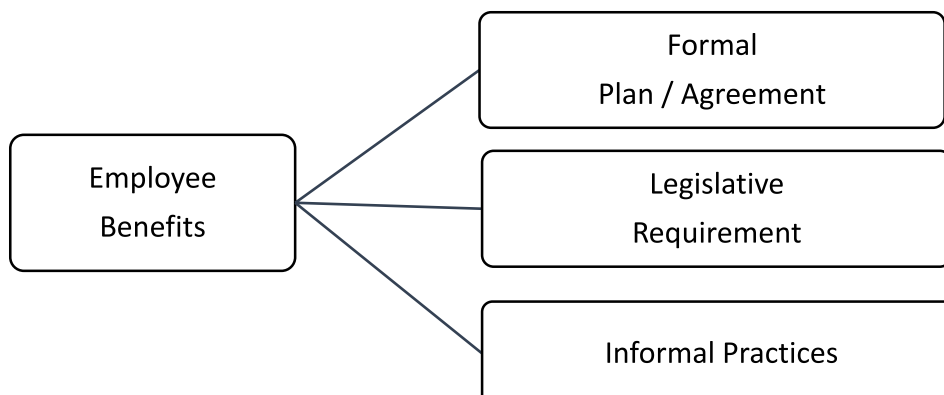
1.1 INTRODUCTION

The Accounting Standard 15 - 'Employee Benefits' (AS 15), generally deals with all forms of employee benefits all forms of consideration given by an enterprise in exchange for services rendered by employees The objective of this Standard is to prescribe the accounting treatment and disclosure for employee benefits in the books of employer except employee share-based payments. It does not deal with accounting and reporting by employee benefit plans.



The Standard addresses only the accounting of employee benefits by employers. The Standard makes four things very clear at the outset:

i. the Standard is applicable to benefits provided to all types of employees (whether full-time, part-time, or casual staff);

ii. employee benefits can be paid in cash or in kind;

iii. employee benefits include benefits provided to employees and their dependents (spouses, children and others); and

iv. payment can be made directly to employees, their dependent or to any other party (e.g., legal heirs, nominees, insurance companies, trust etc.).

The Standard is based on the premise that the costs associated with employees benefits should be matched with the timing of their service. This requires assessment of the anticipated costs and their timing in future and aligning those costs over the period of their service. For example, a bonus payable to an employee for a long-term service, should ideally be spread over the period of his service and the expectations that the employee is expected to complete that service. Likewise, pension payable to an employee must be recognized as a cost during the service period itself, irrespective of the fact that the pension is payable after the service is completed.

(Refer Illustration 1 & 2)

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.

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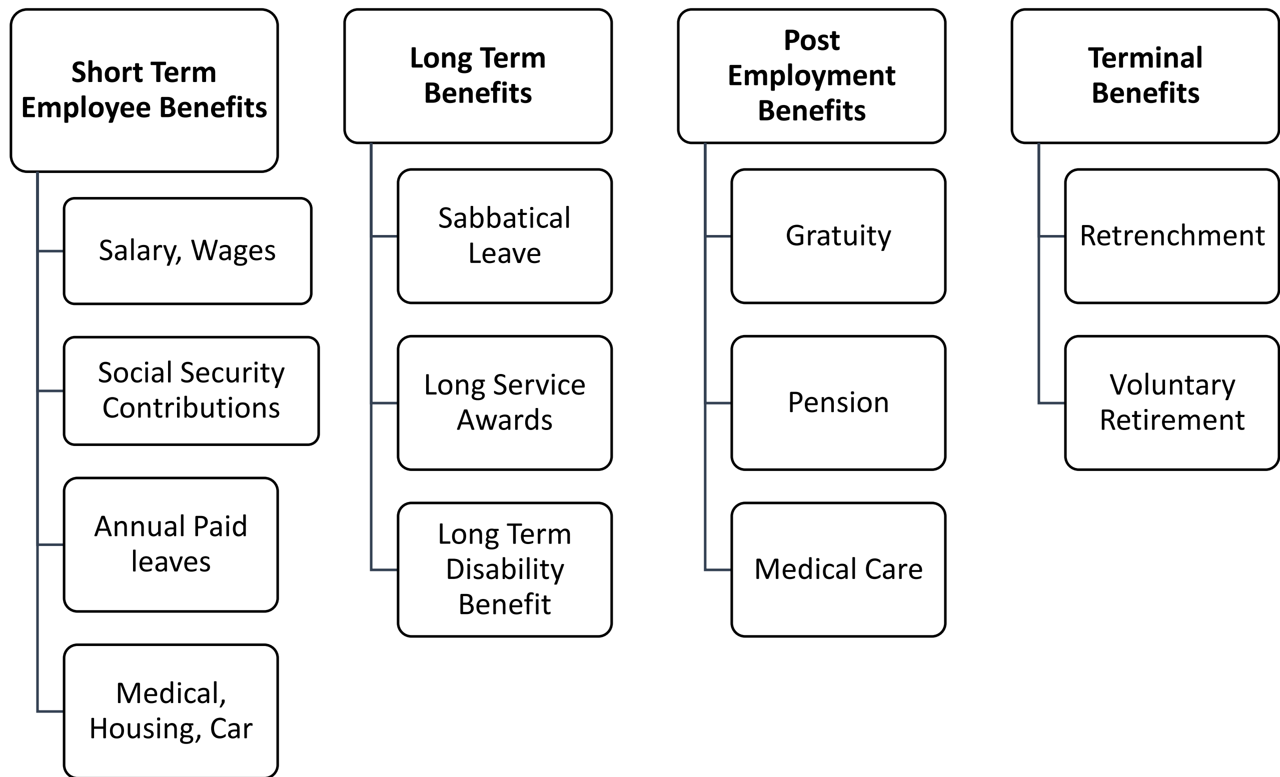

1.2 APPLICABILITY

The Standard applies from April 1, 2006 in its entirety for all Level 1 enterprises. Certain exemptions are given to other than Level 1 enterprises, depending upon whether they employ 50 or more employees. This Standard is applicable predominantly for Level 1 enterprises and applied to other entities with certain relaxations.

1.3 MEANING OF THE TERM "EMPLOYEE BENEFITS"

The term employee is not defined under the standard AS 15 does not define who is an 'employee', but states in that "an employee may provide services to an entity on a full-time, part-time, permanent, casual or temporary basis. For the purpose of this Standard, employees include directors and other management personnel". This suggests that the intention was for the term 'employee' to apply more widely than simply to persons with a contract of employment as 'casual' and 'temporary' staff may frequently not have such contracts.

The following indicators may suggest an employee relationship may be more likely to exist, and may help in making individual judgements:

- A contract of employment exists;
- Individuals are considered employees for legal/tax/social security purposes;
- There is a large amount of oversight and direction by the employer and necessary tools, equipment and materials are provided by the employer;

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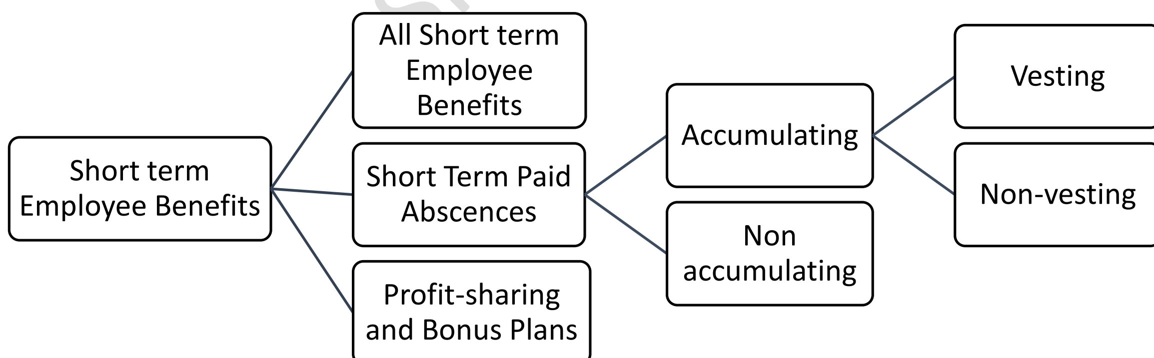
Services are performed at a location specified by the employer; Services provided through an entity are in substance services provided by a specific individual, indications of which could be that the entity:

- Has no other clients;
- Has served the employer for a long period;
- Faces little or no financial risk;
- Requires the explicit permissions of the employer to concurrently undertake additional employment elsewhere.

1.4 SHORT-TERM EMPLOYEE BENEFITS

- Short-term employee benefits (other than termination benefits) are payable within twelve months after the end of the period in which the service is rendered.
- Accounting for these benefits is generally straightforward because no actuarial assumptions are required to measure the obligation or cost.
- Short-term employee benefits are broadly classified into four categories:
  - **i.** Regular period benefits (e.g., wages, salaries);
  - **ii.** Short-term compensated absences (e.g., paid annual leave, maternity leave, sick leave etc.);
  - **iii.** Profit sharing and bonuses payable within twelve months after the end of the period in which employee render the related services and
  - **iv.** Non-monetary benefits (e.g., medical care, housing, cars etc.)



1.4.1 All Short-term Employee Benefits

- The Standard lays down some general recognition criteria for all short-term employee benefits. There are further requirements in respect of short-term compensated absences and profit sharing and bonus plans.
- The general criteria is that an enterprise should recognize as an expense (unless another accounting standard permits a different treatment) the undiscounted amount of all short-term employee benefits attributable to services that been already rendered in the period.

- Any difference between the amount of expenses so recognized and cash payments made during the period should be treated as a liability or prepayment (asset) as appropriate.

(Refer Illustration 3)

1.4.2 Short-term Compensated Absences

Entitlement to compensated absences falls into two categories:

a. Accumulating

- Accumulating compensated absences are those that are carried forward and can be used in future periods if the current period's entitlement is not used in full.
- Accumulating compensated absences may be
  - **i. Vesting**

    It implies that employees are entitled to a cash payment for unused entitlement on leaving the enterprise
  - **ii. Non-vesting**

    It implies that when employees are not entitled to a cash payment for unused entitlement on leaving. An obligation arises as employees render service that increases their entitlement to future compensated absences.
- The expected cost of accumulating compensated absences should be recognized when employees render the service that increase their entitlement to future compensated absences.
- 'An enterprise should measure the expected cost of accumulating compensated absences as the additional amount that the enterprise expects to pay as a result of the unused entitlement that has accumulated at the balance sheet date'.
- No distinction should be made between vesting and non-vesting entitlements. However, in measuring non-vesting entitlements, the possibility of employees leaving the enterprise before receiving them should be taken into account.

Example

An enterprise has 100 employees, who are each entitled to five working days of leave for each year. Unused leave may be carried forward for one calendar year. The leave is taken first out of the current year's entitlement and then out of any balance brought forward from the previous year (a LIFO basis). At 31st December, 20X4, the average unused entitlement is two days per employee. The enterprise expects, based on past experience which is expected to continue, that 92 employees will take no more than five days of leave in 20X5 and that the remaining eight employees will take an average of six and a half days each.

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The enterprise expects that it will pay an additional 12 days of pay as a result of the unused entitlement that has accumulated at 31st December, 20X4 (one and a half days each, for eight employees). Therefore, the enterprise recognises a liability, as at 31st December, 20X4, equal to 12 days of pay.

b. Non-accumulating

- Non-accumulating compensated absences (e.g., maternity leave) do not carry forward and are not directly linked to the services rendered by employees in the past. Therefore, an enterprise recognizes no liability or expense until the time of the absence.
- In other words, the cost of non-accumulating absences should be recognized as and when they arise.

Exception

Small and Medium-sized Company and Micro, Small and Medium-sized Enterprises (Levels IV, III and II non-corporate entities) may not comply with short term absences to the extent they deal with recognition and measurement of absences which are non-vesting (i.e., short-term accumulating compensated absences in respect of which employees are not entitled to cash payment of unused entitlement on leaving).

1.4.3 Profit-sharing and Bonus Plans

Recognition of expenses for profit sharing and bonus plans would depend on fulfillment of conditions mentioned the Standard. The conditions are:

a. Enterprise has a present obligation to make such payments as a result of past events; and

b. Reliable estimate of the obligation can be made.

The second condition can be satisfied only when the profit sharing and bonus plans contained a formula for determining the amount of benefit. The enterprise should recognize the expected cost of profit sharing and bonus payments in the financial statements.

Example

A profit-sharing plan requires an enterprise to pay a specified proportion of its net profit for the year to employees who serve throughout the year. If no employees leave during the year, the total profit-sharing payments for the year will be 3% of net profit. The enterprise estimates that staff turnover will reduce the payments to 2.5% of net profit.

The enterprise recognises a liability and an expense of 2.5% of net profit.

(Refer Illustration 4 & 5)

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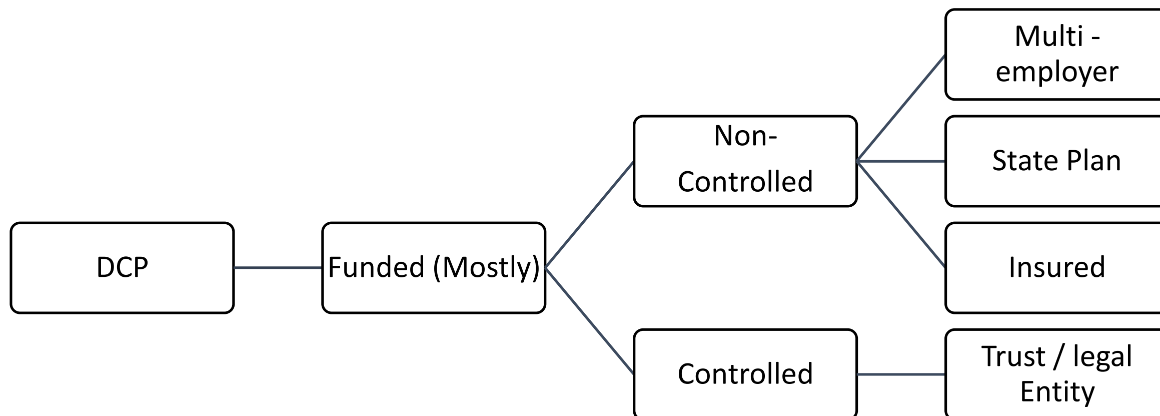
1.5 POST EMPLOYMENT BENEFITS: DEFINED CONTRIBUTION VS DEFINED BENEFITS



The accounting treatment and disclosures required for a post-employment benefit plan depend upon whether it is a defined contribution or a defined benefit plan. In addition to addressing defined contribution and defined benefit plans generally, the Standard also gives guidance as to how its requirements should be applied to insured benefits, multi-employment benefit plans.

1. **Defined contribution plans** (DCP) are post-employment benefit plans under which an enterprise pays fixed contributions into a separate fund and will have no obligation to pay further contributions. Under defined contribution plans, actuarial risk (that benefits will be less than expected) and investment risk (that assets invested will be insufficient to meet expected benefits) fall on the employee. A common example of Defined Contribution plans is Provident Fund.
2. **Defined benefit plans** are post-employment benefit plans other than defined contribution plans. In defined benefits plans, the actuarial and investment risk fall on the employer.
   In defined contribution plans, the contribution is charged to income statement, whereas in defined benefit plans, detailed actuarial calculation is performed to determine the charge.

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1.6 IS THE GRATUITY SCHEME A DEFINED CONTRIBUTION OR DEFINED BENEFIT SCHEME?

An enterprise may pay insurance premiums to fund a post-employment benefit plan. The enterprise should treat such a plan as a defined contribution plan unless the enterprise will have an obligation to either:

a. pay the employee benefits directly when they fall due; or

b. pay further amounts if the insurer does not pay all future employee benefits relating to employee service in the current and prior periods.

On the asset side, a question arises as to whether the funds under the scheme as certified by LIC would be treated as plan assets or reimbursement rights. The distinction is important (though both are measured on fair valuation basis) because plan assets are reduced from the defined benefit obligation and the net amount is disclosed in the balance sheet, whereas, in the case of

reimbursement rights, the defined benefit obligation and the reimbursement rights are shown separately as liability and asset on the balance sheet. This would have the impact of making the balance sheet heavy both on the asset side as well as the liabilities side.

1.7 ACCOUNTING TREATMENT

In the Balance Sheet of the enterprise, 'the amount recognized as a defined benefit liability should be the net total of the following amounts:

a. the present value of the defined benefit obligation at the balance sheet date;

b. minus any past service cost not yet recognized;

c. minus the fair value at the balance sheet date of plan assets (if any) out of which the obligations are to be settled directly.'

In case where fair value of plan assets is high, it may so happen that the net amount under defined benefit liability turns negative (giving rise to net assets). AS 15 states that the enterprise, in such a situation, should measure the resulting asset at the lower of:

i. the amount so determined; and

ii. the present value of any economic benefits available in the form of refunds from the plan or reductions in future contributions to the plan.

The recognition of expenses relating to defined benefits in the Statement of Profit and Loss is stated in Para 61 of the Standard. The Standard identifies seven components of defined employee benefit costs:

a. current service cost;

b. interest cost;

c. the expected return on any plan assets (and on any reimbursement rights);

d. actuarial gains and losses (to the extent they are recognized);

e. past service cost (to the extent they are recognized);

f. the effect of any curtailments or settlements; and

g. the extent to which the negative net amount of defined benefit liability exceeds the amount mentioned in Para 59(b) of the Standard.

A settlement occurs when an employer enters into a transaction that eliminates all further legal or constructive obligations for part or whole of the benefits provided under a defined benefit plan. For example, the commuted portion of pension. A curtailment occurs when an employer either commits to reduce the number of employees covered by a plan or reduces the benefits under a plan. The gains or losses on the settlement or curtailment of a defined benefit plan should be recognized when the settlement or curtailment occurs.

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1.8 DISCLOSURES

Where there is uncertainty about the number of employees who will accept an offer of termination benefits, a contingent liability exists.

As required by AS 29, "Provisions, Contingent Liabilities and Contingent Assets" an enterprise discloses information about the contingent liability unless the possibility of an outflow in settlement is remote.

As required by AS 5, "Net Profit or Loss for the Period, Prior Period items and Changes in Accounting Policies" an enterprise discloses the nature and amount of an expense if it is of such size, nature or incidence that its disclosure is relevant to explain the performance of the enterprise for the period. Termination benefits may result in an expense needing disclosure in order to comply with this requirement.

Where required by AS 18, "Related Party Disclosures", an enterprise discloses information about termination benefits for key management personnel.

When drafting AS 15 (revised), the Standard setters felt that merely on the basis of a detailed formal plan, it would not be appropriate to recognise a provision since a liability cannot be considered to be crystallized at this stage. AS 15 requires more certainty for recognition of termination cost, for example, if the employee has sign up for the termination scheme.

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1.9 ACTUARIAL ASSUMPTIONS

The actuarial assumptions should be unbiased and mutually compatible. They are an enterprise's best estimates of the variables that will determine the ultimate cost of providing post-employment benefits. They should be neither imprudent nor excessively conservative, and should reflect the economic relationships between factors such as inflation, rates of salary increase, return on plan assets and discount rates.

AS 15 explains that actuarial assumptions comprise:

a. demographic assumptions about the future characteristics of current and former employees (and their dependents) who are eligible for benefits. Demographic assumptions deal with matters such as:

- **i.** mortality, both during and after employment;
- **ii.** rates of employee turnover, disability and early retirement;
- **iii.** the proportion of plan members with dependents who will be eligible for benefits;
- **iv.** claim rates under medical plans; and

b. financial assumptions, dealing with items such as:

i. the discount rate
ii. future salary and benefit levels
iii. in the case of medical benefits, future medical costs, including, where material, the cost of administering claims and benefit payments and
iv. the expected rate of return on plan assets

Financial assumptions: Financial assumptions should be based on market expectation at the balance sheet date for the period over which the postemployment benefit obligations will be settled. Discount rates and other financial assumptions should not be inflation-adjusted unless such measures are more reliable (e.g. where benefits are index-linked)

1.10 ACTUARIAL GAINS AND LOSSES

Actuarial gains and losses comprise:

- experience adjustments (the effects of difference between the previous actuarial assumptions and what has actually occurred); and
- the effects of changes in actuarial assumptions.

Actuarial gains and losses should be recognized immediately in the statement of profit and loss as income or expense.

(Refer Illustration 6 - 9)

1.11 OTHER LONG TERM EMPLOYEE BENEFITS

Other long-term employee benefits include, for example:

a. long-term compensated absences such as long-service or sabbatical leave;
b. jubilee or other long-service benefits;
c. long-term disability benefits;
d. profit-sharing and bonuses payable twelve months or more after the end of the period in which the employees render the related services and
e. deferred compensation paid twelve months or more after the end of the period in which it is earned.

1.12 TERMINATION BENEFITS

Termination Benefits are employee benefits payable as a result of either an enterprise's decision to terminate an employee's employment before the normal retirement date or an employee's decision to accept voluntary redundancy in exchange for those benefits (e.g., payments under VRS).

Termination benefits are recognized by an enterprise as a liability and an expense only when the enterprise has

i. a detailed formal plan for the termination which is duly approved, and

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ii. a reliable estimate can be made of the amount of the obligation.

Where the termination benefits fall due within twelve months after the balance sheet date, an undiscounted amount of such benefits should be recognized as liability in the balance sheet with a corresponding charge to Profit & Loss Account. However, when the termination benefits fall due more than twelve months after the balance sheet date, such benefits should be discounted using an appropriate discount rate. Where an offer has been made to encourage voluntary redundancy, the termination benefits should be measured by reference to the number of employees expected to accept the offer. Where there is uncertainty with regard to the number of employees who will accept an offer of voluntary redundancy, a contingent liability exists and should be so disclosed as per AS 29 'Provisions, Contingent Liabilities and Contingent Assets'.

Reference: The students are advised to refer the full text of AS 15 "Employee Benefits" (Revised 2005).

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ILLUSTRATIONS

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

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.

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Illustration 2

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

Solution

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 lump sum 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.

Illustration 3

Entity XY is required to pay salary of Rs. 2 crore for the year 20X1-X2. It actually paid a salary of Rs. 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

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

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.

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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.

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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

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 Rs. 6 lakhs. It wants to spread the same over the next 2 years by reducing the annual contribution to Rs. 2 lakhs instead of Rs. 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

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 Rs. 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 Rs.1,00,000 in respect of a pension plan of Zeleous Ltd. On 30th September, 20X1 the plan paid out benefits of Rs.19,000 and received inward contributions of Rs.49,000. On 31st March, 20X2 the fair value of plan assets was Rs.1,50,000 and present value of the defined benefit obligation was Rs.1,47,920. Actuarial losses on the obligations for the year 20X1- 20X2 were Rs.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 Realised and unrealised	**9.25**
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

Computation of Expected and Actual Returns on Plan Assets

		Rs.
Return on Rs. 1,00,000 held for 12 months at 10.25%		10,250
Return on Rs. 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	49,000	(1,49,000)
		1,000
Add: Benefits paid		19,000
Actual return on plan assets		20,000

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

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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 Rs. 18 (10% of Rs. 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:

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

Solution

Gain from curtailment is estimated as under:

	Rs.
Reduction in gross obligation	600
Less: Proportion of unamortised past service cost	(18)
Gain from curtailment	582

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

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

Illustration 9

An employee Roshan has joined a company XYZ Ltd. in the year 20X1. The annual emoluments of Roshan as decided is Rs. 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.

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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 increments. 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

Calculation of Defined Benefit Obligation (DBO)

Expected last drawn salary = Rs. 14,90,210 x 110% x 110% x 110% x 110% x 110%

= Rs. 24,00,000

Defined Benefit Obligation (DBO) = Rs. 24,00,000 x 25% x 5 = Rs. 30,00,000

Amount of Rs. 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. Rs. 30,00,000/5 years]**	**Discounting @ 8% PV factor**	**Current service cost (Present Value)**
a	b	c	d = b x c
1	6,00,000	0.735 (4 Years)	4,41,000
2	6,00,000	0.794 (3 Years)	4,76,400
3	6,00,000	0.857 (2 Years)	5,14,200
4	6,00,000	0.926 (1 Year)	5,55,600
5	6,00,000	1 (0 Year)	6,00,000

SHRESHTA

Calculation of Interest Cost to be charged per year

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

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

TEST YOUR KNOWLEDGE

MCQs

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**

SHRESHTA

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/SOLUTIONS

MCQs

1.	**c.**	Post-employment benefits.
2.	**c.**	Casual leave
3.	**b.**	State plans
4.	**b.**	Actuarial assumptions
5.	**c.**	Charged immediately to Profit and Loss Statement

THEORETICAL QUESTIONS

Q.NO.1. What are the types of Employees benefits and what is the objective of Introduction of this Standard i.e. AS 15?

ANSWER

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.

SHRESHTA

PRACTICAL QUESTIONS

Q.NO.1. 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

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.

SHRESHTA

Q.NO.2. 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

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

SHRESHTA

Q.NO.3. The fair value of plan assets of Anupam Ltd. was Rs. 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 Rs. 25,000 and received inward contributions of Rs. 55,000. On 31st March, 20X2 the fair value of plan assets was Rs. 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**

SOLUTION

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

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

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

	Rs.	Rs.
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

SHRESHTA

UNIT 2: AS 29 (REVISED): PROVISIONS, CONTINGENT LIABILITIES AND CONTINGENT ASSETS

LEARNING OUTCOMES

After studying this unit, you will be able to comprehend the –

- Meaning of 'Executory contracts', 'Provision', 'Liability, Obligating event' and other related terms used in the standard;
- Need for recognition of provision;
- Definition of Present Obligation and Past Event;
- Probable Outflow of Resources Embodying Economic Benefits;
- Application of the Recognition and Measurement Rules;
- Disclosure requirements as per the Standard.

SHRESHTA

2.1 INTRODUCTION

AS 29 (Revised) came into effect in respect of accounting periods commenced on or after 1-4-2004.

The objective of AS 29 (Revised) is to ensure that appropriate recognition criteria and measurement bases are applied to provisions and contingent liabilities and sufficient information is disclosed in the notes to the financial statements to enable users to understand their nature, timing and amount.

The objective of AS 29 (Revised) is also to lay down appropriate accounting for contingent assets.

Companies would create provisions on arbitrary basis when profits in a particular year is more and then reverse those provisions when profits are lower in subsequent years. This would lead to manipulation of profits. This is popularly known as 'profit smoothing".

Thus, there is a need for certain parameters on the basis of which provisions are measured and recognised, as they impact both Profit and Loss Statement and Balance Sheet (creation of an expense and creation of a liability).

AS-29 prescribes the guidance in respect of recognition, measurement and disclosures of provisions, contingent liabilities and contingent assets.

The standard clearly defines the role of management while making an estimate for creating provisions and the auditors to vouch for the correctness or otherwise of the estimate made by the management. This ensures that manipulations do not take place at the time of creation of provisions.

Earlier, the companies were not recognising the liability on the ground of uncertainty regarding its timing or amount. With the issuance of AS 29, transactions which qualify for creating a provision need to be accounted for in the Balance sheet as a liability.

Example 1

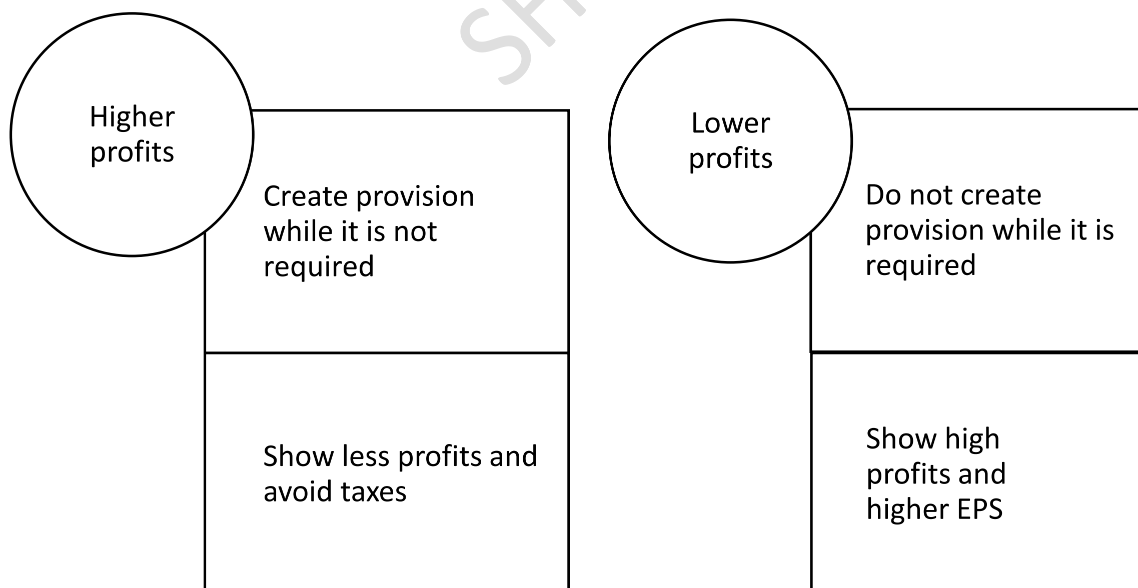
During 20X1, XY Enterprise has made lower amount of profits. However, to ensure that the Earnings Per Share do not decline significantly, XY Enterprise does not provide for a warranty amount which should have been provided for. XY is confident of higher amount of profits during later years, and would like to take this provision to the later stage. This ensures consistent performance for the company throughout the period. With AS 29, this anomaly stands removed.

Example 2

During 20X1, AB Shops has made huge profits during a particular year. This may have resulted in payment of taxes on these profits. Further, AB Shop's management foresees challenges in operations in later years, and therefore, low profits. AB Shop did not create a provision during 20X2 which should have been otherwise made. However, to get the desired impact, AB Shop created the provision in 20X1. Since, the intention of management is not to reflect a true and fair view; AS-29 would ensure appropriate provisions are made in 20X2 only.

AS 29 helps to ensure transparency of information in Financial Statements.

SHRESHTA



Thus, an accounting standard on provisions is essential to rule out the potential scope for companies to manipulate profits and provisions are made on valid grounds (based on a recognition criterion being met).

2.2 SCOPE

AS 29 should be applied in accounting for provisions and contingent liabilities and in dealing with contingent assets, other than:

a. Those resulting from financial instruments that are carried at fair value;

b. Those resulting from executory contracts except where the contract is onerous;

c. Those arising in insurance enterprises from contracts with policy-holders; and

d. Those covered by another Accounting Standard.

Where another Accounting Standard such as AS 7; AS 9; AS 15; AS 19 and AS 22 deals with a specific type of provision, contingent liability or contingent asset, an enterprise applies that Standard instead of AS 29.

2.3 DEFINITIONS

Executory contracts are contracts under which neither party has performed any of its obligations or both parties have partially performed their obligations to an equal extent.

A **Provision** is a liability which can be measured only by using a substantial degree of estimation.

A **Liability** is a present obligation of the enterprise arising from past events, the settlement of which is expected to result in an outflow from the enterprise of resources embodying economic benefits.

An **Obligating event** is an event that creates an obligation that results in an enterprise having no realistic alternative to settling that obligation.

A Contingent liability is:

a. A possible obligation that arises from past events and the existence of which will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the enterprise; or

b. A present obligation that arises from past events but is not recognised because:

   i. It is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation; or

   ii. A reliable estimate of the amount of the obligation cannot be made.

A **Contingent asset** is a possible asset that arises from past events the existence of which will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the enterprise.

Present obligation - an obligation is a present obligation if, based on the evidence available, its existence at the balance sheet date is considered probable, i.e., more likely than not.

Possible obligation - an obligation is a possible obligation if, based on the evidence available, its existence at the balance sheet date is considered **not** probable.

SHRESHTA

A **Restructuring** is a programme that is planned and controlled by management, and materially changes either:

a. The scope of a business undertaken by an enterprise; or

b. The manner in which that business is conducted.

2.4 RECOGNITION OF PROVISION

A provision should be recognised when:

a. An enterprise has a present obligation as a result of a past event;

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

c. A reliable estimate can be made of the amount of the obligation.

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

2.5 PRESENT OBLIGATION

An enterprise determines whether a present obligation exists at the balance sheet date by taking account of all available evidence, e.g., the opinion of experts. Based on such evidence:

a. Where it is more likely than not that a present obligation exists at the balance sheet date, the enterprise recognises a provision (if the recognition criteria are met); and

b. Where it is more likely that no present obligation exists at the balance sheet date, the enterprise discloses a contingent liability, unless the possibility of an outflow of resources embodying economic benefits is remote.

SHRESHTA

Example 3

X Ltd sells refrigerators with a warranty of 6 months. The refrigerators would be repaired free of cost by X Ltd. if some problem arises during the next 6 months of sale. There is a present obligation for X Ltd because if some defect arises, X Ltd would need to incur expenses on repairs of the refrigerator. Thus, a provision is required to be made in the books of X Ltd.

Example 4

Z Ltd takes a building on lease for 10 years. The terms of the contract provide that Z Ltd must vacate the building in its original condition. Z Ltd expects that there is a likely cost of Rs. 10 lakhs to be spent at the end of 10 years for restoration. Since there is a present obligation on X Ltd at the time of entering into the lease contract, a provision to the extent of present value of this amount should be created.

2.6 PAST EVENT

A past event that leads to a present obligation is called an obligating event. For an event to be an obligating event, it is necessary that the enterprise has no realistic alternative to settling the obligation created by the event.

Financial statements deal with the financial position of an enterprise at the end of its reporting period and not its possible position in the future.

Therefore, no provision is recognised for costs that need to be incurred to operate in the future. The only liabilities recognised in an enterprise's balance sheet are those that exist at the balance sheet date.

It is only those obligations arising from past events existing independently of an enterprise's future actions (i.e. the future conduct of its business) that are recognised as provisions.

Examples of such obligations are penalties or clean-up costs for unlawful environmental damage, both of which would lead to an outflow of resources embodying economic benefits in settlement regardless of the future actions of the enterprise.

Similarly, an enterprise recognises a provision for the decommissioning costs of an oil installation to the extent that the enterprise is obliged to rectify damage already caused. In contrast, because of commercial pressures or legal requirements, an enterprise may intend or need to carry out expenditure to operate in a particular way in the future (for example, by fitting smoke filters in a certain type of factory). Because the enterprise can avoid the future expenditure by its future actions, for example by changing its method of operation, it has no present obligation for that future expenditure and no provision is recognised.

An event that does not give rise to an obligation immediately may do so at a later date, because of changes in the law. For example, when environmental damage is caused there may be no obligation to remedy the consequences. However, the causing of the damage will become an obligating event when a new law requires the existing damage to be rectified.

Where details of a proposed new law have yet to be finalized, an obligation arises only when the legislation is virtually certain to be enacted.

2.7 PROBABLE OUTFLOW OF RESOURCES EMBODYING ECONOMIC BENEFITS

For a liability to qualify for recognition there must be not only a present obligation but also the probability of an outflow of resources embodying economic benefits to settle that obligation.

For the purpose of AS 29, an outflow of resources or other event is regarded as probable if the probability that the event will occur is greater than the probability that it will not. Where it is not probable that a present obligation exists, an enterprise discloses a contingent liability, unless the possibility of an outflow of resources embodying economic benefits is remote.

Where there are a number of similar obligations (e.g., product warranties or similar contracts) the probability that an outflow will be required in settlement is determined by considering the class of obligations as a whole. Although the likelihood of outflow for any one item may be small, it may well be probable that some outflow of resources will be needed to settle the class of obligations as a whole. If that is the case, a provision is recognized (if the other recognition criteria are met).

SHRESHTA

Example 5

Kell Ltd sells laptops with a replacement warranty of 1 year. If something happens to the laptop within 1 year of purchase, the company would replace the complete laptop. A few laptops during past years have been replaced by Kell Ltd.

In the above situation, Kell Ltd would incur some expenses to replace a laptop, if something goes wrong. There is an outflow of resources expected to settle the obligation that arises by virtue of sale of laptop (past event).

Example 6

AB Ltd has received a notice from one of the customers about health issues from using the products of AB Ltd. The customer in the notice claims damages of Rs. 5,00,000.

The conditions of past event (i.e. sale of goods resulting in damage) and reliable estimate (Rs. 5,00,000) have been met. However, whether an outflow of resources will be probable or not, cannot be confirmed since the customer may or may not win the case. This would be clear only when the decision will be taken by the court. Hence, in the above situation, no provision for damages will be made. However, a disclosure of the case filed is required to be made.

SHRESHTA

2.8 RELIABLE ESTIMATE OF THE OBLIGATION

The use of estimates is an inherent part of preparing financial statements and does not undermine their reliability. Provisions require a greater degree of estimation than most other items, but AS 29 (Revised) emphasizes that it should not be impossible to determine a range of possible outcomes and, from this range, to reach an appropriate conclusion that is sufficiently reliable for the provision to be recognized. AS 29 (Revised) concludes that the circumstances in which it will not be possible to reach a reliable estimate, will be extremely rare.

In the extremely rare case where no reliable estimate can be made, a liability exists that cannot be recognized. That liability will, instead, be disclosed as a contingent liability.

For example: XYZ is in mining business. It is operating in a country where XYZ is legally bound to clean and restore the environment on expiry of license after 10 years. XYZ can reliably estimate the amount required to restore the environment caused by the mining business. Since it if a present obligation which cannot be avoided resulted from past event, it is probable that resources will flow out of business to settle the same and estimate can be measured reliably. XYZ is required to recognize a provision for the same.

2.9 CONTINGENT LIABILITIES

An enterprise should not recognize a contingent liability but should be disclosed. A contingent liability is disclosed, unless the possibility of an outflow of resources embodying economic benefits is remote.

Where an enterprise is jointly and severally liable for an obligation, the part of the obligation that is expected to be met by other parties is treated as a contingent liability. The enterprise recognizes a provision for the part of the obligation for which an outflow of resources embodying economic benefits is probable, except in the extremely rare circumstances where no reliable estimate can be made.

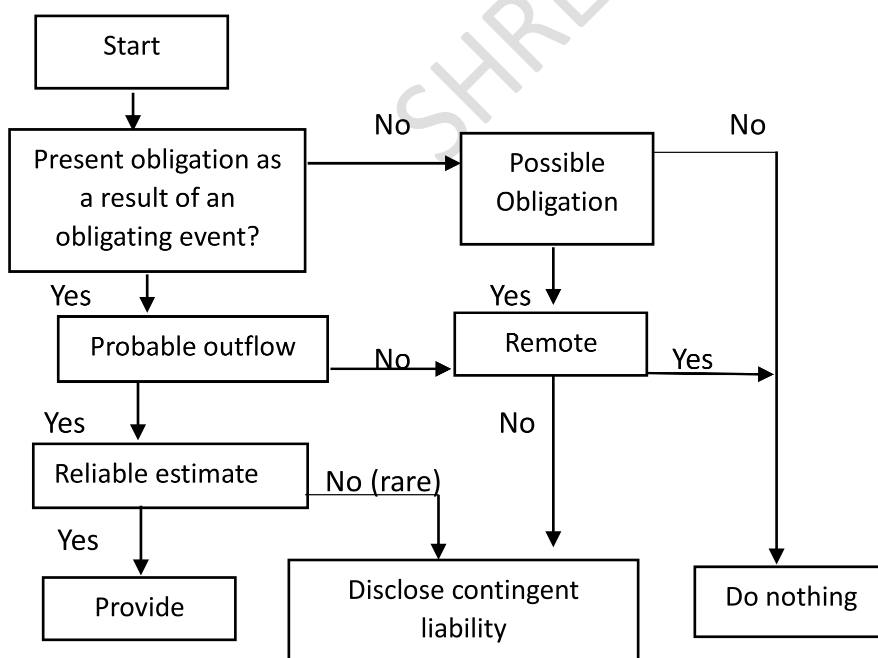
Contingent liabilities may develop in a way not initially expected. Therefore, they are assessed continually to determine whether an outflow of resources embodying economic benefits has become probable. If it becomes probable that an outflow of future economic benefits will be required for an item previously dealt with as a contingent liability, a provision is recognized in the financial statements of the period in which the change in probability occurs.

Example: 7

A customer of XYZ has filed a case against them for providing them wrong product and not returning the same. XYZ has taken legal advice from their lawyer who believes it is not probable yet that resources may be required to settle the same.

Since it is not meeting all the criteria of provision, it will be treated as contingent liability and will just be disclosed in the notes.

Decision tree



SHRESHTA

2.10 CONTINGENT ASSETS

Contingent assets usually arise from unplanned or other unexpected events that give rise to the possibility of an inflow of economic benefits to the enterprise. An example is a claim that an enterprise is pursuing through legal processes, where the outcome is uncertain.

An enterprise should not recognize a contingent asset, since this may result in the recognition of income that may never be realized. However, when the realization of income is virtually certain, then the related asset is not a contingent asset and its recognition is appropriate. A contingent asset is not disclosed in the financial statements. It is usually disclosed in the report of the approving authority (Board of Directors in the case of a company, and, the corresponding approving authority in the case of any other enterprise), where an inflow of economic benefits is probable.
Contingent assets are assessed continually and if it has become virtually certain that an inflow of economic benefits will arise, the asset and the related income are recognized in the financial statements of the period in which the change occurs.

Table- Provisions and contingent liabilities

Where, as a result of past events, there may be an outflow of resources embodying future economic benefits in settlement of: (a) a present obligation the one whose existence at the balance sheet date is considered probable; or (b) a possible obligation the existence of which at the balance sheet date is considered not probable.		
There is a present obligation that probably requires an outflow of resources and a reliable estimate can be made of the amount of obligation.	There is a possible obligation or a present obligation that may, but probably will not, require an outflow of resources.	There is a possible obligation or a present obligation where the likelihood of an outflow of resources is remote.
Provision is recognised.	No provision is recognised.	No provision is recognised.
Disclosures are required for the provision.	Disclosures are required for the contingent liability.	No disclosure is required.

SHRESHTA

2.11 MEASUREMENT: BEST ESTIMATE

The amount recognised as a provision should be the best estimate of the expenditure required to settle the present obligation at the balance sheet date.

The estimates of outcome and financial effect are determined by:

- the judgment of the management of the enterprise,
- supplemented by experience of similar transactions and,
- in some cases, reports from independent experts.

The amount of a provision should not be discounted to its present value except in case of decommissioning, restoration and similar liabilities that are recognised as cost of Property, Plant and Equipment.

The discount rate (or rates) should be a pre-tax rate (or rates) that reflect(s) current market assessments of the time value of money and the risks specific to the liability. The discount rate(s) should not reflect risks for which future cash flow estimates have been adjusted. Periodic unwinding of discount should be recognised in the statement of profit and loss.

The provision is measured before tax; the tax consequences of the provision, and changes in it, are dealt with under AS 22.

2.12 RISKS AND UNCERTAINTIES

The risks and uncertainties that inevitably surround many events and circumstances should be taken into account in reaching the best estimate of a provision.

2.13 FUTURE EVENTS

It is only those obligations arising from past events that exist independently of the enterprise's future actions (i.e. the future conduct of its business) that are recognized as provisions.

Future events that may affect the amount required to settle an obligation should be reflected in the amount of a provision where there is sufficient objective evidence that they will occur.

For example, an enterprise may believe that the cost of cleaning up a site at the end of its life will be reduced by future changes in technology. The amount recognized reflects a reasonable expectation of technically qualified, objective observers, taking account of all available evidence as to the technology that will be available at the time of the clean-up. Thus, it is appropriate to include, for example, expected cost reductions associated with increased experience in applying existing technology or the expected cost of applying existing technology to a larger or more complex clean-up operation than has previously been carried out. However, an enterprise does not anticipate the development of a completely new technology for cleaning up unless it is supported by sufficient objective evidence.

The effect of possible new legislation is taken into consideration in measuring an existing obligation when sufficient objective evidence exists that the legislation is virtually certain to be enacted. The variety of circumstances that arise in practice usually makes it impossible to specify a single event that will provide sufficient, objective evidence in every case. Evidence is required both of what legislation will demand and of whether it is virtually certain to be enacted and implemented in due course. In many cases sufficient objective evidence will not exist until the new legislation is enacted.

2.14 EXPECTED DISPOSAL OF ASSETS

Gains on the expected disposal of assets **are not taken into account** in measuring a provision, even if the expected disposal is closely linked to the event giving rise to the provision. Instead, an enterprise recognizes gains on expected disposals of assets at the time specified by the Accounting Standard dealing with the assets concerned.

SHRESHTA

2.15 REIMBURSEMENTS

An enterprise with a present obligation may be able to seek reimbursement of part or all of the expenditure from another party, for example via:

- An insurance contract arranged to cover a risk;
- An indemnity clause in a contract; or
- A warranty provided by a supplier.

The basis underlying the recognition of a reimbursement is that any asset arising is separate from the related obligation. Consequently, such a reimbursement should be recognized only when it is virtually certain that it will be received consequent upon the settlement of the obligation.

In most cases, the enterprise will remain liable for the whole of the amount in question so that the enterprise would have to settle the full amount if the third party failed to pay for any reason. In this situation, a provision is recognized for the full amount of the liability, and a separate asset for the expected reimbursement is recognized when it is virtually certain that reimbursement will be received if the enterprise settles the liability.

In some cases, the enterprise will not be liable for the costs in question if the third party fails to pay. In such a case, the enterprise has no liability for those costs and they are not included in the provision.

SHRESHTA

2.16 TABLE- REIMBURSEMENTS

Some or all of the expenditure required to settle a provision is expected to be reimbursed by another party.		
The enterprise has no obligation for the part of the expenditure to be reimbursed by the other party.	The obligation for the amount expected to be reimbursed remains with the enterprise and it is virtually certain that reimbursement will be received if the enterprise settles the provision.	The obligation for the amount expected to be reimbursed remains with the enterprise and the reimbursement is not virtually certain if the enterprise settles the provision.
The enterprise has no liability for the amount to be reimbursed.	The reimbursement is recognized as a separate asset in the balance sheet and may be offset against the expense in the statement of	The expected reimbursement is not recognized as an asset.

	profit and loss. The amount recognized for the expected reimbursement does not exceed the liability.	
No disclosure is required.	The reimbursement is disclosed together with the amount recognized for the reimbursement.	The expected reimbursement is disclosed.

2.17 CHANGES IN PROVISIONS

Provisions should be reviewed at each balance sheet date and adjusted to reflect the current best estimate. If it is no longer probable that an outflow of resources embodying economic benefits will be required to settle the obligation, the provision should be reversed.

2.18 USE OF PROVISIONS

A provision should be used only for expenditures for which the provision was originally recognized. Only expenditures that relate to the original provision are adjusted against it. Adjusting expenditures against a provision that was originally recognized for another purpose would conceal the impact of two different events.

SHRESHTA

2.19 APPLICATION OF THE RECOGNITION AND MEASUREMENT RULES

2.19.1 Future Operating Losses

Future operating losses **do not meet the definition of a liability** and the general recognition criteria; therefore, provisions should not be recognized for future operating losses.

2.19.2 Restructuring

The following are examples of events that may fall under the definition of restructuring:

a. Sale or termination of a line of business

b. The closure of business locations in a country or region or the relocation of business activities from one country or region to another

c. Changes in management structure, for example, eliminating a layer of management

d. Fundamental re-organizations that have a material effect on the nature and focus of the enterprise's operations

A provision for restructuring costs is recognized only when the recognition criteria for provisions are met. No obligation arises for the sale of an operation until the enterprise is committed to the sale, i.e., there is a binding sale agreement. Until there is a binding sale agreement, the enterprise will be able to change its mind and indeed will have to take another course of action if a purchaser cannot be found on acceptable terms.

A restructuring provision should include only the direct expenditures arising from the restructuring, which are those that are both:

a. Necessarily entailed by the restructuring; and

b. Not associated with the ongoing activities of the enterprise.

A restructuring provision does not include such costs as:

a. Retraining or relocating continuing staff;

b. Marketing; or

c. Investment in new systems and distribution networks.

These expenditures relate to the future conduct of the business and are not liabilities for restructuring at the balance sheet date. Such expenditures are recognized on the same basis as if they arose independently of a restructuring.

Identifiable future operating losses up to the date of a restructuring are not included in a provision.

Gains on the expected disposal of assets are not taken into account in measuring a restructuring provision, even if the sale of assets is envisaged as part of the restructuring.

2.20 DISCLOSURE

For each class of provision, an enterprise should disclose:

a. The carrying amount at the beginning and end of the period;

b. Additional provisions made in the period, including increases to existing provisions;

c. Amounts used (i.e., incurred and charged against the provision) during the period; and

d. Unused amounts reversed during the period.

Note: SMCs are exempt from the above disclosure requirements of AS 29 (Revised)

An enterprise should disclose the following for each class of provision:

a. A brief description of the nature of the obligation and the expected timing of any resulting outflows of economic benefits;

b. An indication of the uncertainties about those outflows. Where necessary to provide adequate information, an enterprise should disclose the major assumptions made concerning future events, and

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c. The amount of any expected reimbursement, stating the amount of any asset that has been recognized for that expected reimbursement.

Note: SMCs are exempt from the above disclosure requirements of AS 29 (Revised)

Unless the possibility of any outflow in settlement is remote, an enterprise should disclose for each class of contingent liability at the balance sheet date a brief description of the nature of the contingent liability and, where practicable:

a. An estimate of its financial effect,

b. An indication of the uncertainties relating to any outflow; and

c. The possibility of any reimbursement.

Where any of the information required by above paragraph is not disclosed because it is not practicable to do so, that fact should be stated.

In extremely rare cases, disclosure of some or all of the information required by AS 29 can be expected to prejudice seriously the position of the enterprise in a dispute with other parties on the subject matter of the provision or contingent liability. In such cases, an enterprise need not disclose the information, but should disclose the general nature of the dispute, together with the fact that, and reason why, the information has not been disclosed.

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ILLUSTRATIONS

Illustration 1

At the end of the financial year ending on 31st December, 20X1, a company finds that there are twenty law suits outstanding which have not been settled till the date of approval of accounts by the Board of Directors. The possible outcome as estimated by the Board is as follows:

	Probability	Loss (Rs.)
In respect of five cases (Win)	100%	–
Next ten cases (Win)	50%	–
Lose (Low damages)	40%	1,20,000
Lose (High damages)	10%	2,00,000
Remaining five cases		
Win	50%	–
Lose (Low damages)	30%	1,00,000
Lose (High damages)	20%	2,10,000

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

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Solution

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

i. There is a present obligation arising out of past events but not recognized as provision.

ii. It is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation.

iii. The possibility of an outflow of resources embodying economic benefits is not remote.

iv. The amount of the obligation cannot be measured with sufficient reliability to be recognized as provision.

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

Expected loss in next ten cases = 40% of Rs. 1,20,000 + 10% of Rs. 2,00,000

= Rs. 48,000 + Rs. 20,000 = Rs. 68,000

Expected loss in remaining five cases = 30% of Rs. 1,00,000 + 20% of Rs. 2,10,000

= Rs. 30,000 + Rs. 42,000 = Rs. 72,000

To disclose contingent liability on the basis of maximum loss will be highly unrealistic. Therefore, the better approach will be to disclose the overall expected loss of Rs. 10,40,000 (Rs. 68,000 × 10 + Rs. 72,000 × 5) as contingent liability.

Illustration 2

EXOX Ltd. is in the process of finalising its accounts for the year ended 31st March, 20X2. The company seeks your advice on the following:

i. The Company's sales tax assessment for assessment year 20X1-X2 has been completed on 14th February, 20X4 with a demand of Rs. 2.76 crore. The company paid the entire due under protest without prejudice to its right of appeal. The Company files its appeal before the appellate authority wherein the grounds of appeal cover tax on additions made in the assessment order for a sum of 2.10 crore.

ii. The Company has entered into a wage agreement in May, 20X2 whereby the labour union has accepted a revision in wage from June, 20X1. The agreement provided that the hike till May, 20X2 will not be paid to the employees but will be settled to them at the time of retirement. The company agrees to deposit the arrears in Government Bonds by September, 20X2.

Solution

i. Since the company is not appealing against the addition of Rs. 0.66 crore the same should be provided for in its accounts for the year ended on 31st March, 20X4. The amount paid under protest can be kept under the heading 'Loans & Advances' and disclosed as a contingent liability of Rs. 2.10 crore.

ii. The arrears for the period from June, 20X1 to March, 20X2 are required to be provided for in the accounts of the company for the year ended on 31st March, 20X2.

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TEST YOUR KNOWLEDGE

MCQs

1. **Which of the following best describes a provision?**
   a. **A provision is a liability of uncertain timing or amount.**
   b. **A provision is a possible obligation of uncertain timing.**
   c. **A provision is a credit balance set up to offset a contingent asset so that the effect on the statement of financial position is nil.**
   d. **A provision is a possible obligation of uncertain amount.**

2. **X Co is a business that sells second hand cars. If a car develops a fault within 30 days of the sale, X Co will repair it free of charge. At 1st March 20X1, X Co had made a provision for repairs of Rs.25,000. At 31st March 20X1, X Co calculated that the provision should be Rs.20,000. What entry should be made for the provision in X Co's income statement for the month 31st March 20X1?**
   a. **A charge of Rs. 5,000**
   b. **A credit of Rs. 5,000**
   c. **A charge of Rs. 20,000**
   d. **A credit of Rs. 25,000**

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3. **Which of the following item does the statement below describe? "A possible obligation that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the entity's control"**
   a. **A provision**
   b. **A current liability**
   c. **A contingent liability**
   d. **Deferred tax liability**

4. **Z Ltd has commenced a legal action against Y Ltd claiming substantial damages for supply of a faulty product. The lawyers of Y Ltd have advised that the company is likely to lose the case, although the chance of paying the claim is not remote. The estimated potential liability estimated by the lawyers are:**
   Legal cost (to be incurred irrespective of the outcome of the case) Rs. 50,000 Settlement if the claim is required to be paid Rs. 5,00,000 What is the appropriate accounting treatment in the books of Z Ltd.?

a. **Create a Provision of Rs. 5,50,000**

b. **Make a Disclosure of a contingent liability of Rs. 5,50,000**

c. **Create a Provision of Rs. 50,000 and make a disclosure of contingent liability of Rs. 5,00,000**

d. **Create a Provision of Rs. 5,00,000**

ANSWERS/SOLUTIONS

1.	**a.**	A provision is a liability of uncertain timing or amount.
2.	**b.**	A credit of Rs.5,000
3.	**c.**	A contingent liability
4.	**c.**	Create a Provision of Rs.50,000 and make a disclosure of contingent liability of Rs.5,00,000

THEORY QUESTIONS

Q.NO.1. When should provision be recognized as per provisions of AS 29? Explain in brief.

ANSWER

A provision should be recognised only when: (a) An enterprise has a present obligation as a result of a past event; (b) It is probable that an outflow of resources embodying economic benefits will be required to settle the obligation; and (c) A reliable estimate can be made of the amount of the obligation.

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PRACTICAL QUESTIONS

Q.NO.1. Sun Ltd. has entered into a sale contract of Rs. 5 crores with X Ltd. during 20X1-20X2 financial year. The profit on this transaction is Rs. 1 crore. The delivery of goods to take place during the first month of 20X2-20X3 financial year. In case of failure of Sun Ltd. to deliver within the schedule, a compensation of Rs. 1.5 crores is to be paid to X Ltd. Sun Ltd. planned to manufacture the goods during the last month of 20X1-20X2 financial year. As on balance sheet date (31.3.20X2), the goods were not manufactured, and it was unlikely that Sun Ltd. will be able to meet the contractual obligation.

i. Should Sun Ltd. provide for contingency as per AS 29?

ii. Should provision be measured as the excess of compensation to be paid over the profit?

SOLUTION

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

ii. Provision should not be measured as the excess of compensation to be paid over the profit. The goods were not manufactured before 31st March, 20X2 and no profit had accrued for the financial year 20X1-20X2. Therefore, provision should be made for the full amount of compensation amounting Rs. 1.50 crores.

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Q.NO.2. An oil company has been contaminating land for several years. It does not clean up because there is no legislation requiring cleaning up. At 31st March 20X1, it is virtually certain that a law requiring a clean-up of land already contaminated will be enacted shortly after the year end. Is provisioning presently necessary?

SOLUTION

As per para 29 of AS 29 'Provisions, Contingent Liabilities and Contingent Assets', a past event will lead to present obligation when the enterprise has no realistic alternative to settle the obligation created by the past event.

However, when environmental damage is caused, there may be no obligation to remedy the consequences. The causing of the damage will become an obligating event when a new law requires the existing damage to be rectified. Where details of a proposed new law have yet to be finalised, an obligation arises only when the legislation is virtually certain to be enacted.

In the given case it is virtually certain that law will be enacted requiring clean-up of a land already contaminated. Therefore, an oil company has to provide for such clean-up cost in the year in which the law is virtually certain to be enacted.

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7. ACCOUNTING STANDARDS BASED ON ITEMS IMPACTING FINANCIAL STATEMENTS

UNIT 1: ACCOUNTING STANDARD 4: CONTINGENCIES AND EVENTS OCCURRING AFTER THE BALANCE SHEET DATE

LEARNING OUTCOMES

After studying this unit, you will be able to elucidate the –

- Meaning of Contingencies and accounting treatment of contingent gains and contingent losses.
- Events Occurring after the Balance Sheet Date: Adjusting and Non-adjusting events
- Necessary Disclosures required as per the standard.

1.1 INTRODUCTION

All paragraphs of AS 4 (Revised) that deal with contingencies are applicable only to the extent not covered by other Accounting Standards prescribed by the Central Government. For example, the impairment of financial assets such as impairment of receivables (commonly known as provision for bad and doubtful debts) is governed by this Standard. Thus, the present standard (AS 4 (Revised)) deals with the treatment and disclosure requirements in the financial statements of events occurring after the balance sheet.

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1.2 CONTINGENCIES

Contingency is a condition or situation, the ultimate outcome of which, gain or loss, will be known or determined only on the occurrence, or non-occurrence, of one or more uncertain future events.

Accounting Treatment of Contingent Losses

The accounting treatment of a contingent loss is determined by the expected outcome of the contingency. If it is likely that a contingency will result in a loss to the enterprise, then it is prudent to provide for that loss in the financial statements.

Example: ABC has filed case against a debtor for a recovery of Rs.25 Lakhs. According to the legal team, the chances of recovery is nil. Therefore, ABC should make provision for doubtful debt.

The estimation of the amount of a contingent loss to be provided for in the financial statements may be based on judgement made, by the management. If there is conflicting or insufficient evidence for estimating the amount of a contingent loss, then disclosure is made of the existence and nature of the contingency.

The estimates of the outcome and of the financial effect of contingencies are determined by the judgment of the management of the enterprise. This judgment is based on consideration of the information available up to the date on which the financial statements are approved and will include a review of events occurring after the balance sheet date, supplemented by experience of similar transactions and, in some cases, reports from independent experts.

The existence and amount of guarantees, obligations arising from discounted bills of exchange and similar obligations undertaken by an enterprise are generally disclosed in financial statements by way of note, even though the possibility that a loss to the enterprise will occur, is remote.

Accounting Treatment of Contingent Gains

Contingent gains are not recognised in financial statements since their recognition may result in the recognition of revenue which may never be realised. However, when the realisation of a gain is virtually certain, then such gain is not a contingency and accounting for the gain is appropriate.

The amount at which a contingency is stated in the financial statements is based on the information which is available at the date on which the financial statements are approved.

1.3 EVENTS OCCURRING AFTER THE BALANCE SHEET DATE

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

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For example, for the year ending on 31st March 20X1, financial statement is finalized and approved by the Board of the directors of the company in its meeting held on 04th September 20X1. In this case the events taking place between 01st April 20X1 to 04th September 20X1 are termed as events occurring after the balance sheet date.

Two types of events can be identified:

a. **Adjusting events**- those which provide further evidence of conditions that existed at the balance sheet date. For example, a trade receivable declared insolvent after reporting date and unable to pay full amount against whom provision for doubtful debt was created.
b. **Non-adjusting events**- those which are indicative of conditions that arose subsequent to the balance sheet date. For example, plant got damaged due to occurrence of fire.

1.4 ADJUSTING EVENTS

Adjustments to assets and liabilities are required for events occurring after the balance sheet date that provide additional information materially affecting the determination of the amounts relating to conditions existing at the balance sheet date. For example, an adjustment may be made for a loss on a trade receivable account which is confirmed by the insolvency of a customer which occurs after the balance sheet date.

1.5 NON-ADJUSTING EVENTS

Adjustments to assets and liabilities are not appropriate for events occurring after the balance sheet date, if such events do not relate to conditions existing at the balance sheet date. An example is the decline in market value of investments between the balance sheet date and the date on which the financial statements are approved. Ordinary fluctuations in market values do not normally relate to the condition of the investments at the balance sheet date but reflect circumstances which have occurred in the following period.

Events occurring after the balance sheet date which do not affect the figures stated in the financial statements would not normally require disclosure in the financial statements although they may be of such significance that they may require a disclosure in the report of the approving authority to enable users of financial statements to make proper evaluations and decisions.

Dividend declared after balance sheet date

There are events which, although take place after the balance sheet date, are sometimes reflected in the financial statements because of statutory requirements or because of their special nature. For example, if dividends are declared after the balance sheet date but before the financial statements are approved, the dividends are not recognised as a liability at the balance sheet date because no obligation exists at that time unless a statute requires otherwise. Such dividends are disclosed in the notes. Thus, no liability for proposed dividends needs to be recognised in the financial statements for financial year ended 31st March, 2017 and subsequent years. Such proposed dividends are to be disclosed in the notes as per Companies (Accounting Standards) Amendment Rules, 2016 issued on 30 March 2016.

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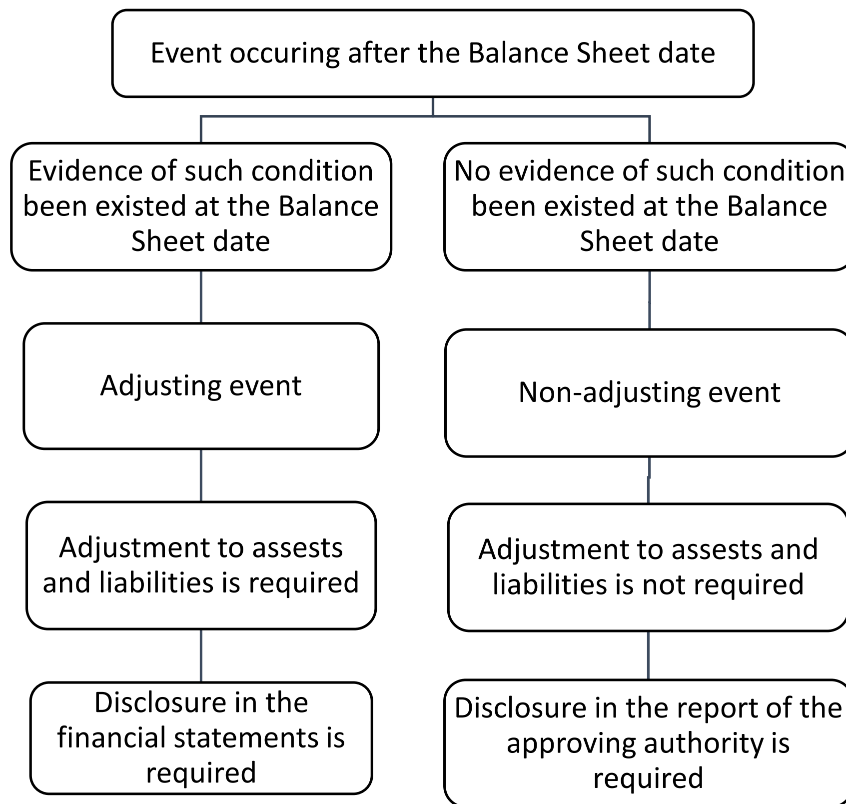
Events indicating going concern assumption inappropriate

Events occurring after the balance sheet date may indicate that the enterprise ceases to be a **going concern**. A deterioration in operating results and financial position, or unusual changes affecting the existence or substratum of the enterprise after the balance sheet date (e.g., destruction of a major production plant by a fire after the balance sheet date) may indicate a need to consider whether it is proper to use the fundamental accounting assumption of going concern in the preparation of the financial statements. In case the going concern, assumption is not valid (based on events occurring after the balance sheet date), the financial statements are prepared on a liquidation basis.



1.6 DISCLOSURE

Disclosure of events occurring after the balance sheet date requires the following information be provided in the financial statements:

a. The nature of the event;

b. An estimate of the financial effect, or a statement that such an estimate cannot be made.

Example

A company follows April-March as its financial year. The company recognises cheques dated 31st March or before, received from customers after the balance sheet date but before approval of financial statement by debiting Cheques in hand A/c and crediting the Debtors A/c. The Cheques in hand are shown in the balance sheet as an item of cash and cash equivalents. All Cheques in hand are presented to bank in the month of April and are also realised in the same month in the normal course after deposit in the bank.

Even if the cheques bear the date 31st March or before, the cheques received after 31st March do not represent any condition existing on 31st March. Thus the collection of cheques after balance sheet date is not an adjusting event. Recognition of cheques in hand is therefore not consistent with the requirements of AS 4 (Revised). Moreover, the collection of cheques after balance sheet date does not represent any material change or commitments affecting financial position of the enterprise, and so no disclosure of such collections in the Directors' Report is necessary.

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It should also be noted that, the Framework for Preparation and Presentation of Financial Statement defines assets as resources controlled by an enterprise as a result of past events from which economic benefits are expected to flow to the enterprise. Since the company acquires custody of the cheques after 31st March, it does not have any control over the cheques on 31st March and hence cheques in hand do not qualify to be recognised as asset on 31st March. Illustration 1 In X Co. Ltd., theft of cash of Rs.5 lakhs by the cashier in January, 20X1 was detected only in May, 20X1. The accounts of the company were not yet approved by the Board of Directors of the company.

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ILLUSTRATIONS

Illustration 1

In X Co. Ltd., theft of cash of Rs.5 lakhs by the cashier in January, 20X1 was detected only in May, 20X1. The accounts of the company were not yet approved by the Board of Directors of the company. Decide whether the theft of cash has to be adjusted in the accounts of the company for the year ended 31.3.20X1.

Solution

As per AS 4 (Revised) 'Contingencies and Events occurring after the Balance Sheet Date', an event occurring after the balance sheet date may require adjustment to the reported amounts of assets, liabilities, expenses or incomes.

If a fraud of the accounting period is detected after the balance sheet date but before approval of the financial statements, it is necessary to recognise the loss amounting Rs.5,00,000 and adjust the accounts of the company for the year ended 31st March, 20X1.

Illustration 2

An earthquake destroyed a major warehouse of ACO Ltd. on 20.5.20X2. The accounting year of the company ended on 31.3.20X2. The accounts were approved on 30.6.20X2. The loss from earthquake is estimated at Rs.30 lakhs. State with reasons, whether the loss due to earthquake is an adjusting or non-adjusting event and how the fact of loss is to be disclosed by the company.

Solution

AS 4 (Revised) "Contingencies and Events Occurring after the Balance Sheet Date", states that adjustments to assets and liabilities are not appropriate for events occurring after the balance sheet date, if such events do not relate to conditions existing at the balance sheet date. The destruction of warehouse due to earthquake did not exist on the balance sheet date i.e. 31.3.20X2. Therefore, loss occurred due to earthquake is not to be recognised in the financial year 20X1- 20X2.

However, according to the standard, unusual changes affecting the existence or substratum of the enterprise after the balance sheet date may indicate a need to consider the use of fundamental accounting assumption of going concern in the preparation of the financial statements. As per the information given in the question, the earthquake has caused major destruction; therefore, fundamental accounting assumption of going concern would have to be evaluated. Considering that the going concern assumption is still valid, the fact of earthquake together with an estimated loss of Rs.30 lakhs should be disclosed in the report of the approving authority for financial year 20X1-X2 to enable users of financial statements to make proper evaluations and decisions.

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Illustration 3

A company has filed a legal suit against the debtor from whom Rs.15 lakh is recoverable as on 31.3.20X1. The chances of recovery by way of legal suit are not good as per legal opinion given by the counsel in April, 20X1. Can the company provide for full amount of Rs.15 lakhs as provision for doubtful debts? Discuss.

Solution

As per AS 4 (Revised) "Contingencies and Events Occurring After the Balance Sheet Date", assets and liabilities should be adjusted for events occurring after the balance sheet date that provide additional evidence to assist the estimation of amounts relating to conditions existing at the balance sheet date. In the given case, company should make the provision for doubtful debts, as legal suit has been filed on 31st March, 20X1 and the chances of recovery from the suit are not good. Though, the actual result of legal suit will be known in future yet situation of non-recovery from the debtors exists before finalisation of financial statements. Therefore, provision for doubtful debts should be made for the year ended on 31st March, 20X1.

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Illustration 4

In preparing the financial statements of R Ltd. for the year ended 31st March, 20X1, you come across the following information. State with reasons, how you would deal with this in the financial statements:

The company invested 100 lakhs in April, 20X1 before approval of Financial Statements by the Board of directors in the acquisition of another company doing similar business, the negotiations for which had started during the year.

Solution

AS 4 (Revised) defines "Events Occurring after the Balance Sheet Date" as those significant events, both favourable and unfavourable, that occur between the balance sheet date and the date on which the financial statements are approved by the Approving Authority in the case of a company. Accordingly, the acquisition of another company is an event occurring after the balance sheet date. However, no adjustment to assets and liabilities is required as the event does not affect the determination and the condition of the amounts stated in the financial statements for the year ended 31st March, 20X1. The disclosure should be made in the report of the approving authority of those events occurring after the balance sheet date that represent material changes and commitments affecting the financial position of the enterprise, the investment of Rs.100 lakhs in April, 20X1 for the acquisition of another company should be disclosed in the report of the Approving Authority to enable users of financial statements to make proper evaluations and decisions.

Illustration 5

A Limited Company closed its accounting year on 30.6.20X1 and the accounts for that period were considered and approved by the board of directors on 20th August, 20X1. The company was engaged in laying pipeline for an oil company deep beneath the earth. While doing the boring work on 1.9.20X1 it had met a rocky surface for which it was estimated that there would be an extra cost to the tune of Rs.80 lakhs. You are required to state with reasons, how the event would be dealt with in the financial statements for the year ended 30.6.20X1.

Solution

AS 4 (Revised) on Contingencies and Events Occurring after the Balance Sheet Date defines 'events occurring after the balance sheet date' as 'significant events, both favourable and unfavourable, that occur between the balance sheet date and the date on which financial statements are approved by the Board of Directors in the case of a company'. The given case is discussed in the light of the above-mentioned definition and requirements given in AS 4 (Revised). In this case the incidence, which was expected to push up cost, became evident after the date of approval of the accounts. So it is not an 'event occurring after the balance sheet date'.

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Illustration 6

While preparing its final accounts for the year ended 31st March, 20X1 a company made a provision for bad debts @ 5% of its total trade receivables. In the last week of February, 20X1 a trade receivable for Rs.2 lakhs had suffered heavy loss due to an earthquake; the loss was not covered by any insurance policy. In April, 20X1 the trade receivable became a bankrupt. Can the company provide for the full loss arising out of insolvency of the trade receivable in the final accounts for the year ended 31st March, 20X1?

Solution

As per Accounting Standard 4, Assets and Liabilities should be adjusted for events occurring after the balance sheet date that provide additional evidence to assist estimation of amounts relating to conditions existing at the balance sheet date.

So full provision for bad debt amounting to Rs.2 lakhs should be made to cover the loss arising due to the insolvency in the Final Accounts for the year ended 31st March, 20X1. It is because earthquake took place before the balance sheet date.

Had the earthquake taken place after 31st March, 20X1, then this would have been treated as non-adjusting event and only disclosure required as per AS 4 (Revised), would have been sufficient.

Illustration 7

Y Ltd. has book debts and has a doubt over recoverability of some of the book debts. The amount that cannot be recovered is not quantifiable. Thus, Y Ltd. is of the opinion that provision for doubtful debts should not be created. Y Ltd. creates provision for certain other expenses on estimated basis.

Whether contention of Y Ltd. is correct?

Solution

As per AS 4, "Contingencies and Events Occurring After the Balance Sheet Date" if it is likely that a contingency will result in a loss to an entity then it should create provision for that contingency on the estimated basis.

Based on the above, the contention that provision for doubtful debt is not be created merely because the amount is not quantifiable is not correct. Hence Y Ltd. should make provision in the books on the basis of estimation.

Reference: The students are advised to refer the full text of AS 4 (Revised) “Contingencies∗ and Events occurring after the Balance Sheet Date”.

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TEST YOUR KNOWLEDGE

MCQs

1. **Cash amounting to Rs.4 lakhs, stolen by the cashier in the month of March 20X1, was detected in April, 20X1. The financial statements for the year ended 31st March, 20X1 were approved by the Board of Directors on 15th May, 20X1. As per Accounting Standards, this is _____ for the financial statements year ended on 31st March, 20X1.**
   a. **An Adjusting event.**
   b. **Non-adjusting event.**
   c. **Contingency.**
   d. **Provision**

2. **As per Accounting Standards, events occurring after the balance sheet date are**
   a. **Only favourable events that occur between the balance sheet date and the date when the financial statements are approved by the Board of directors.**
   b. **Only unfavourable events that occur between the balance sheet date and the date when the financial statements are approved by the Board of directors.**
   c. **Those significant events, both favourable and unfavourable, that occurs between the balance sheet date and the date on which the financial statements are approved by the Board of directors.**
   d. **Those significant events, both favourable and unfavourable, that occurs between the balance sheet date and the date on which the financial statements are not approved by the Board of directors.**

3. **AS 4 does not apply to**
   a. **Obligation under retirement benefit plans.**
   b. **Commitments arising from long term lease contracts.**
   c. **liabilities of life assurance and general insurance enterprises arising from policies issued**
   d. **Both a. & b.**

4. **A Ltd. sold its building for Rs.50 lakhs to B Ltd. and has also given the possession to B Ltd. The book value of the building is Rs.30 lakhs. As on 31st March, 20X1, the documentation and legal formalities are pending. For the financial year ended 31st March, 20X1**
   a. **The company should record the sale.**

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b. **The company should recognise the profit of Rs.20 lakhs in its profit and loss account.**

c. **Both a. and b.**

d. **The company should disclose the profit of Rs.20 lakhs in notes to accounts.**

ANSWERS/SOLUTION

MCQ

1.	**a.**	An Adjusting event.
2.	**c.**	Those significant events, both favourable and unfavourable, that occur between the balance sheet date and the date on which the financial statements are approved by the Board of directors.
3.	**d.**	Both a. & b.
4.	**c.**	Both a. and b.

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PRACTICAL QUESTIONS

Q.NO.1. A Ltd. has sold its building for Rs.50 lakhs to B Ltd. and has also given the possession to B Ltd. The book value of the building is Rs.30 lakhs. As on 31st March, 20X1, the documentation and legal formalities are pending. The company has not recorded the sale and has shown the amount received as advance. Do you agree with this treatment?

SOLUTION

The economic reality and substance of the transaction is that the rights and beneficial interest in the property has been transferred although legal title has not been transferred. A Ltd. should record the sale and recognise the gain of Rs.20 lakhs in its profit and loss account. The building should be derecognized in the financial statements.

Q.NO.2. During the year 20X1-20X2, Raj Ltd. was sued by a competitor for Rs.15 lakhs for infringement of a trademark. Based on the advice of the company's legal counsel, Raj Ltd. provided for a sum of Rs.10 lakhs in its financial statements for the year ended 31st March, 20X2. On 18th May, 20X2, the Court decided in favour of the party alleging infringement of the trademark and ordered Raj Ltd. to pay the aggrieved party a sum of Rs.14 lakhs. The financial statements were prepared by the company's management on 30th April, 20X2, and approved by the board on 30th May, 20X2.

SOLUTION

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

In the given case, since Raj Ltd. was sued by a competitor for infringement of a trademark during the year 20X1-X2 for which the provision was also made by it, the decision of the Court on 18th May, 20X2, for payment of the penalty will constitute as an adjusting event because it is an event occurred before approval of the financial statements. Therefore, Raj Ltd. should adjust the provision upward by Rs.4 lakhs to reflect the award decreed by the Court to be paid by them to its competitor.

Had the judgment of the Court been delivered on 1st June, 20X2, it would be considered as an event occurring after the approval of the financial statements which is not covered by AS 4 (Revised). In that case, no adjustment in the financial statements of 20X1-X2 would have been required.

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UNIT 2: ACCOUNTING STANDARD 5: NET PROFIT OR LOSS FOR THE PERIOD, PRIOR PERIOD ITEMS AND CHANGES IN ACCOUNTING POLICIES

LEARNING OUTCOMES

After studying this unit, you will be able to comprehend the meaning and accounting treatment for

- Net Profit or Loss for the Period
- Extraordinary Items
- Profit or Loss from Ordinary Activities
- Prior Period Items
- Changes in Accounting Estimates
- Changes in Accounting Policies.

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2.1 INTRODUCTION

The objective of AS 5 is to prescribe the classification and disclosure of certain items in the statement of profit and loss so that all enterprises prepare and present such a statement on a uniform basis. This enhances the comparability of the financial statements of an enterprise over time and with the financial statements of other enterprises. Accordingly, AS 5 requires the classification and disclosure of extraordinary and prior period items, and the disclosure of certain items within profit or loss from ordinary activities.

This Statement does not deal with the tax implications of extraordinary items, prior period items, changes in accounting estimates, and changes in accounting policies for which appropriate adjustments will have to be made depending on the circumstances.

2.2 NET PROFIT OR LOSS FOR THE PERIOD

All items of income and expense which are recognized in a period should be included in the determination of net profit or loss for the period unless an Accounting Standard requires or permits otherwise.

The net profit or loss for the period comprises the following components, each of which should be disclosed on the face of the statement of profit and loss:

a. **Profit or loss from ordinary activities**

Any activities which are undertaken by an enterprise as part of its business and such related activities in which the enterprise engages in furtherance of, incidental to, or arising from, these activities. For example, profit on sale of merchandise, loss on sale of unsold inventory at the end of the season.

b. **Extraordinary items**

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

Extraordinary items should be disclosed in the statement of profit and loss as a part of net profit or loss for the period.

The nature and the amount of each extraordinary item should be separately disclosed in the statement of profit and loss or in notes to accounts in a manner that its impact on current profit or loss can be perceived. Whether an event or transaction is clearly distinct from the ordinary activities of the enterprise is determined by the nature of the event or transaction in relation to the business ordinarily carried on by the enterprise rather than by the frequency with which such events are expected to occur. Therefore, an event or transaction may be extraordinary for one enterprise but not so for another enterprise because of the differences between their respective ordinary activities. For example, losses sustained as a result of an earthquake may qualify as an extraordinary item for many enterprises. However, claims from policyholders arising from an earthquake do not qualify as an extraordinary item for an insurance enterprise that insures against such risks.

Examples of events or transactions that generally give rise to extraordinary items for most enterprises are:

– attachment of property of the enterprise

– an earthquake

c. **Exceptional items**

When items of income and expense within profit or loss from ordinary activities are of such size, nature or incidence that their disclosure is relevant to explain the performance of the enterprise for the period, the nature and amount of such items should be disclosed separately.

Circumstances which may give rise to the separate disclosure of items of income and expense include:

a. The write-down of inventories to net realisable value as well as the reversal of such write-downs

b. A restructuring of the activities of an enterprise and the reversal of any provisions for the costs of restructuring

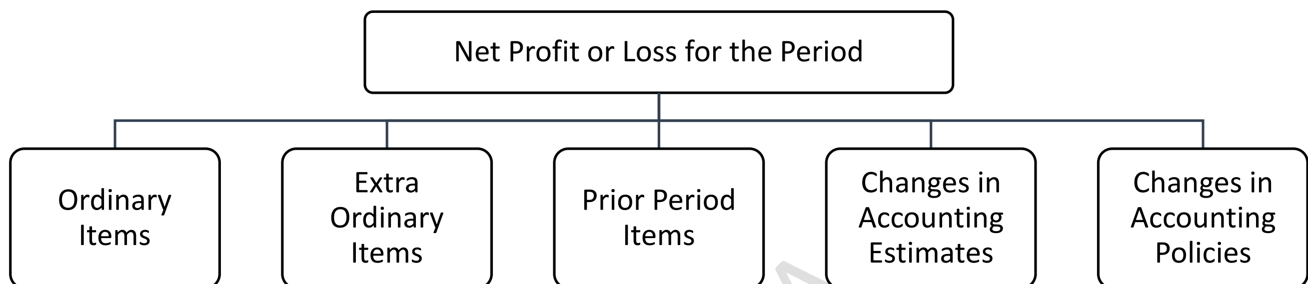
c. Disposals of items of property, plant and equipment

d. Disposals of long-term investments

e. Legislative changes having retrospective application

f. Litigation settlements

g. Other reversals of provisions



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2.3 PRIOR PERIOD ITEMS

Prior period items are income or expenses which arise in the current period as a result of errors or omissions in the preparation of the financial statements of one or more prior periods.

Errors may occur as a result of mathematical mistakes, mistakes in applying accounting policies, mis-interpretation of facts, or oversight.

The nature and amount of prior period items should be separately disclosed in the statement of profit and loss in a manner that their impact on the current profit or loss can be perceived.

Prior period items are generally infrequent in nature and can be distinguished from changes in accounting estimates. Accounting estimates by their nature are approximations that may need revision as additional information becomes known. For example, income or expense recognised on the outcome of a contingency which previously could not be estimated reliably does not constitute a prior period item.

Prior period items are normally included in the determination of net profit or loss for the current period. An alternative approach is to show such items in the statement of profit and loss after determination of current net profit or loss. In either case, the objective is to indicate the effect of such items on the current profit or loss.

2.4 CHANGES IN ACCOUNTING ESTIMATES

Accounting estimates by their nature are approximations that may need revision as additional information becomes known. For example, income or expense recognised on the outcome of a contingency which previously could not be estimated reliably does not constitute a prior period item.

For example, Sachin purchased a new machine costing Rs.10 lacs. Useful life was taken to be for 10 years, therefore, depreciation was charged at 10% on original cost each year. After 5 years when carrying amount was Rs.5 lacs for the machine, management realises that machine can work for another 2 years only. In this case machine will be depreciated by Rs.2.5 lacs each year for next 2 years. This is not an example of prior period item but change in accounting estimate.

In the same example, let us suppose there is no change in useful life of the machine after 5 years. The management by mistake calculated the depreciation in the fifth year as 10% of Rs.6,00,000 i.e., Rs.60,000 instead of Rs.1,00,000 and in the next year i.e., sixth year decides to charge depreciation of Rs.1,40,000. In such a case, Rs.1,00,000 would be the depreciation of sixth year and Rs.40,000 depreciation charged by the management in the sixth year will be considered as a prior period item.

As per AS 10 (Revised), Property, Plant and Equipment, residual value and the useful life of an asset should be reviewed at least at each financial year-end and, if expectations differ from previous estimates, the change should be accounted for as a change in an accounting estimate in accordance with AS 5 'Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies'.

The effect of a change in an accounting estimate should be included in the determination of net profit or loss in:

a. The period of the change, if the change affects the period only; or

b. The period of the change and future periods, if the change affects both.

For example, a change in the estimate of the amount of bad debts is recognised immediately and therefore affects only the current period. However, a change in the estimated useful life of a depreciable asset affects the depreciation in the current period and in each period during the remaining useful life of the asset.

The effect of a change in an accounting estimate should be classified using the same classification in the statement of profit and loss as was used previously for the estimate.

To ensure the comparability of financial statements of different periods, the effect of a change in an accounting estimate which was previously included in the profit or loss from ordinary activities is included in the same component of net profit or loss. The effect of a change in an accounting estimate that was previously included as an extraordinary item is reported as an extraordinary item.

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The nature and amount of a change in an accounting estimate which has a material effect in the current period, or which is expected to have a material effect in subsequent periods, should be disclosed. If it is impracticable to quantify the amount, this fact should be disclosed.
Sometimes, it is difficult to distinguish between a change in an accounting policy and a change in an accounting estimate. In such cases, the change is treated as a change in an accounting estimate, with appropriate disclosure.

2.5 CHANGES IN ACCOUNTING POLICIES

Accounting policies are the specific accounting principles and the methods of applying those principles adopted by an enterprise in the preparation and presentation of financial statements.
Accounting Policies can be changed only:

- when the adoption of a different accounting policy is required by statute; or
- for compliance with an Accounting Standard; or
- when it is considered that the change would result in a more appropriate presentation of the financial statements of the enterprise.

The following are not changes in accounting policies:

a. The adoption of an accounting policy for events or transactions that differ in substance from previously occurring events or transactions, e.g., introduction of a formal retirement gratuity scheme by an employer in place of ad hoc ex-gratia payments to employees on retirement;

b. The adoption of a new accounting policy for events or transactions which did not occur previously or that were immaterial.

Any change in an accounting policy which has a material effect should be disclosed. The impact of, and the adjustments resulting from, such change, if material, should be shown in the financial statements of the period in which such change is made, to reflect the effect of such change. Where the effect of such change is not ascertainable, wholly or in part, the fact should be indicated. If a change is made in the accounting policies which has no material effect on the financial statements for the current period but which is reasonably expected to have a material effect in later periods, the fact of such change should be appropriately disclosed in the period in which the change is adopted.

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ILLUSTRATIONS

Illustration 1

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

Solution

No, the company is not correct in treating the amount written off as a prior period item. As per AS 5, prior period items are income or expenses which arise in a current year due to errors or omissions in the preparation of the financial statements of one or more prior period(s).

Writing off an old outstanding balance in the current year which is appearing in its books of accounts from the past 5 financial years does not mean that there has been an error or omission in the preparation of financial statements of prior period(s). It is just a practice adopted by the company to write off the old outstanding balances of more than 5 years in its current year books of accounts. Therefore, the amount written off is not treated as a prior period item.

Hence, adjusting the amount ₹ 50,000 written off as a prior period item on the basis that sundry balances were recognized in prior period(s) is not in line with AS 5.

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Illustration 2

Fuel surcharge is billed by the State Electricity Board at provisional rates. Final bill for fuel surcharge of Rs.5.30 lakhs for the period October, 20X1 to September, 20X7 has been received and paid in February, 20X8. However, the same was accounted in the year 20X8-X9. Comment on the accounting treatment done in the said case.

Solution

The final bill having been paid in February, 20X8 should have been accounted for in the annual accounts of the company for the year ended 31st March, 20X8. However, it seems that as a result of error or omission in the preparation of the financial statements of prior period i.e., for the year ended 31st March 20X8, this material charge has arisen in the current period i.e., year ended 31st March, 20X9. Therefore, it should be treated as 'Prior period item' as per AS 5. As per AS 5, prior period items are normally included in the determination of net profit or loss for the current period.

An alternative approach is to show such items in the statement of profit and loss after determination of current net profit or loss. In either case, the objective is to indicate the effect of such items on the current profit or loss.

It may be mentioned that it is an expense arising from the ordinary course of business. Although abnormal in amount or infrequent in occurrence, such an expense does not qualify an extraordinary item as per AS 5. For better understanding, the fact that power bill is accounted for at provisional rates billed by the state electricity board and final adjustment thereof is made as and when final bill is received may be mentioned as an accounting policy.

Illustration 3

i. **During the year 20X1-20X2, a medium size manufacturing company wrote down its inventories to net realisable value by Rs.5,00,000. Is a separate disclosure necessary?**
ii. **A company signed an agreement with the Employees Union on 1.9.20X2 for revision of wages with retrospective effect from 30.9.20X1. This would cost the company an additional liability of Rs.5,00,000 per annum. Is a disclosure necessary for the amount paid in 20X2-X3?**

Solution

i. Although the case under consideration does not relate to extraordinary item, but the nature and amount of such item may be relevant to users of financial statements in understanding the financial position and performance of an enterprise and in making projections about financial position and performance. AS 5 on 'Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies' states that:

   "When items of income and expense within profit or loss from ordinary activities are of such size, nature or incidence that their disclosure is relevant to explain the performance of the enterprise for the period, the nature and amount of such items should be disclosed separately." Circumstances which may require separate disclosure of items of income and expense in accordance with AS 5 include the write-down of inventories to net realisable value as well as the reversal of such write-downs.

ii. It is given that revision of wages took place on 1st September, 20X2 with retrospective effect from 30.9.20X1. Therefore wages payable for the half year from 1.10.20X2 to 31.3.20X3 cannot be taken as an error or omission in the preparation of financial statements and hence this expenditure cannot be taken as a prior period item. Additional wages liability of Rs.7,50,000 (for 1½ years @ Rs.5,00,000 per annum) should be included in current year's wages.

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It may be mentioned that additional wages is an expense arising from the ordinary activities of the company. Such an expense does not qualify as an extraordinary item. However, as per AS 5, when items of income and expense within profit or loss from ordinary activities are of such size, nature or incidence that their disclosure is relevant to explain the performance of the enterprise for the period, the nature and amount of such items should be disclosed separately.

Illustration 4

The company finds that the inventory sheets of 31.3.20X1 did not include two pages containing details of inventory worth Rs.14.5 lakhs. State, how you will deal with the following matters in the accounts of Omega Ltd. for the year ended 31st March, 20X2.

Solution

AS 5 on 'Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies', defines Prior Period items as "income or expenses which arise in the current period as a result of errors or omissions in the preparation of the financial statements of one or more prior periods". Rectification of error in inventory valuation is a prior period item vide AS 5. Separate disclosure of this item as a prior period item is required as per AS 5.

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Illustration 5

Explain whether the following will constitute a change in accounting policy or not as per AS 5. (i) Introduction of a formal retirement gratuity scheme by an employer in place of ad hoc ex-gratia payments to employees on retirement. (ii) Management decided to pay pension to those employees who have retired after completing 5 years of service in the organisation. Such employees will get pension of Rs.20,000 per month. Earlier there was no such scheme of pension in the organisation.

Solution

As per AS 5 'Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies', the adoption of an accounting policy for events or transactions that differ in substance from previously occurring events or transactions, will not be considered as a change in accounting policy.

i. Accordingly, introduction of a formal retirement gratuity scheme by an employer in place of ad hoc ex-gratia payments to employees on retirement is not a change in an accounting policy.

ii. Similarly, the adoption of a new accounting policy for events or transactions which did not occur previously or that were immaterial will not be treated as a change in an accounting policy.

Illustration 6

In the current year, A Ltd. changed the depreciation method from the Straight-Line Method (SLM) to Written Down Value (WDV) method. When A Ltd. recomputed depreciation retrospectively as per the new method, deficiency arose in depreciation in respect of past years. Therefore, it reduced the carrying amount of the asset by the amount of deficiency and such change in carrying amount (deficiency amount) has been debited to the statement of profit and loss as an extraordinary expense.

Whether the change in the carrying amount of assets due to the change in depreciation method should be treated as an extraordinary item?

Solution

No.

As per AS 5, "Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies" extraordinary items are income or expenses that arise from events or transactions that are clearly distinct from the ordinary activities of the enterprise and, therefore, are not expected to recur frequently or regularly. A change in the method of charging depreciation is not an event that is clearly distinct from the ordinary activities of the entity. In the instant case, A Ltd. has changed the depreciation method and treated the reduction in carrying amount (or amount of deficiency in depreciation) of the asset as an extraordinary expense. This is not correct. Such deficiency should be treated as a normal expense.

A change in the estimated useful life of a depreciable asset (i.e. change in depreciation method) affects the depreciation in the current period and in each period during the remaining useful life of the asset. In both cases, the effect of the change relating to the current period is recognised as income or expense in the current period. The effect, if any, on future periods, is recognised in future periods.

The change in depreciation method is considered as a change in accounting estimate as per the provisions of AS 5.

Reference: The students are advised to refer the full text of AS 5" Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies".

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TEST YOUR KNOWLEDGE

MCQs

1. **A change in the estimated life of the asset, which necessitates adjustment in the depreciation is an example of**
   a. **Prior period item.**
   b. **Ordinary item.**
   c. **Extraordinary item.**
   d. **Change in accounting estimate.**

2. **Which of the following is considered as an extraordinary item as per AS 5?**
   a. **Write down or write-off of receivables, inventory and intangible assets.**
   b. **Gains and losses from sale or abandonment of equipment used in a business.**
   c. **Effects of a strike, including those against competitors and major suppliers.**
   d. **Flood damage from unusually heavy rain or a normally dry environment.**

3. **Which one of the following is an example of extraordinary item?**
   a. **The write down of inventories to their net realisable value**
   b. **Reversal of write down of inventories**
   c. **Government grants become refundable**
   d. **Reversal of provisions.**

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4. **Extraordinary items are income or expenses**
   a. **That arise from events clearly distinct from the ordinary activities of the enterprise.**
   b. **That are not expected to recur frequently or regularly.**
   c. **Both (a) and (b).**
   d. **None of the three.**

5. **An audit stock verification during the year ended 31st March, 20X1 revealed that opening stock of the year was understated by Rs.5 lakhs due to wrong counting. While finalizing accounts, your opinion will be**
   a. **It is not a prior period item and no separate disclosure is required**
   b. **It should be treated as a prior period adjustment and should be separately disclosed in the current year's financial statement**
   c. **The adjustment of Rs.5 lakhs in both opening stock of current year and profit brought forward from previous year should be made**
   d. **Both (b) and (c)**

ANSWERS/SOLUTION

MCQ

1.	**d.**	Change in accounting estimate.
2.	**d.**	Flood damage from unusually heavy rain or a normally dry environment.
3.	**c.**	Government grants become refundable
4.	**c.**	Both (a) and (b).
5.	**d.**	Both (b) and (c)

PRACTICAL QUESTIONS

Q.NO.1. A company (Z Ltd.) is engaged in the business of providing consultancy services. A few days back, it received a notice from GST department raising a demand of GST on consultancy services provided by it for Rs. 500,000. Recently Z Ltd. paid the demand. In the books, the payment is recorded as an extraordinary expenditure.

Whether payment of tax demand raised by the taxation authority can be recognised as an extraordinary item?

SOLUTION

No, payment of tax cannot be recognised as an extraordinary item. As per AS 5, "Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies" an extraordinary item is income or expenses that arise from events or transactions that are clearly distinct from ordinary activities of the enterprise and, therefore, are not expected to recur frequently or regularly.

In the given case, providing consultancy service is an ordinary activity of Z Ltd. Thus, GST paid pursuant to the demand raised by GST department is also a part of an ordinary activity of Z Ltd. Recognising such payments as an extra-ordinary item is contrary to AS 5.

SHRESHTA

UNIT 3: ACCOUNTING STANDARD 11: THE EFFECTS OF CHANGES IN FOREIGN EXCHANGE RATES

LEARNING OUTCOMES

After studying this unit, you will be able to comprehend the –

- Foreign Currency Transactions
    - Initial Recognition
    - Reporting at Subsequent Balance Sheet Dates
    - Recognition of Exchange Differences
- Net Investment in a Non-integral Foreign Operation
- Classification of Foreign Operations
    - Integral Foreign Operations
    - Non-integral Foreign Operations
    - Disposal of a Non-integral Foreign Operation
    - Change in the Classification of a Foreign Operation
    - Accounting for Forward Exchange Contracts
    - Disclosures

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3.1 INTRODUCTION

An enterprise may carry on activities involving foreign exchange in two ways. It may have transactions in foreign currencies (e.g., export sales in denominated in USD) or it may have foreign operations (e.g., foreign branch of reporting entity outside India). At the time of preparing the financial statements, these transactions and/or operations must be reported by the entity in the reporting currency i.e., INR. Hence, such foreign currency transactions and foreign operations should be translated into the reporting currency (i.e., INR) in order to be included in the financial statements of the entity.

Scope

This Standard should be applied:

a. In accounting for transactions in foreign currencies.

b. In translating the financial statements of foreign operations.

c. This Statement also deals with accounting for foreign currency transactions in the nature of forward exchange contracts.

This Standard does not:

a. Specify the currency in which an enterprise presents its financial statements. However, an enterprise normally uses the currency of the country in which it is domiciled. If it uses a different currency, the Standard requires disclosure of the reasons for using that currency. The Standard also requires disclosure of the reason for any change in the reporting currency.

For example, all Indian companies are required to present their financial statements in INR. Thus, for such entities, INR is the reporting currency.

Alternatively, in case an Indian company is a subsidiary of a company located in the United States, the parent may require the company to present the financial statements in USD. In such cases, the company is required to disclose the reasons for presenting the financial statements in USD (a currency other than INR, the currency of the place where the company is domiciled i.e., India).

In both the cases discussed above, it may be pertinent to note that Accounting Standard 11 does not prescribe the currency to be used to present the financial statements. However, for all practical purposes (Income Tax Act, Indirect Tax Requirements etc.), every company domiciled in India will present financial statements in INR.

b. Deal with the presentation in a cash flow statement of cash flows arising from transactions in a foreign currency and the translation of cash flows of a foreign operation, which are addressed in AS 3 'Cash flow statement'.

c. Deal with the restatement of an enterprise's financial statements from its reporting currency into another currency for the convenience of users accustomed to that currency or for similar purposes.

Considering the example above, the Indian subsidiary of the US Parent will present its financial statements in INR for the Indian regulators. However, since the US parent needs to consolidate the Indian subsidiary, it will require the Indian company to also restate the INR Financial Statements to USD. Such restatement is not covered under Accounting Standard 11.

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3.2 DEFINITIONS OF THE TERMS USED IN THE STANDARD

A foreign currency transaction is a transaction which is denominated in or requires settlement in a foreign currency, including transactions arising when an enterprise either:

a. Buys or sells goods or services whose price is denominated in a foreign currency.

b. Borrows or lends funds when the amounts payable or receivable are denominated in a foreign currency.

c. Becomes a party to an unperformed forward exchange contract or

d. Otherwise acquires or disposes of assets, or incurs or settles liabilities, denominated in a foreign currency.

Monetary items are money held and assets and liabilities to be received or paid in fixed or determinable amounts of money. For example, cash, receivables and payables.

Non-monetary items are assets and liabilities other than monetary items. For example, fixed assets, advances for purchase of goods / fixed assets, inventories and investments in equity shares.

Foreign operation is a subsidiary, associate, joint venture or branch of the reporting enterprise, the activities of which are based or conducted in a country other than the country of the reporting enterprise.

Integral foreign operation is a foreign operation, the activities of which are an integral part of those of the reporting enterprise. A foreign operation that is integral to the operations of the reporting enterprise carries on its business as if it were an extension of the reporting enterprise's operations.

Non-integral foreign operation is a foreign operation that is not an integral foreign operation. When there is a change in the exchange rate between the reporting currency and the local currency, there is little or no direct effect on the present and future cash flows from operations of either the non-integral foreign operation or the reporting enterprise. The change in the exchange rate affects the reporting enterprise's net investment in the non-integral foreign operation rather than the individual monetary and non-monetary items held by the non-integral foreign operation.

'Net investment in a non-integral foreign operation' is the reporting enterprise's share in the net assets of that operation.

Forward exchange contract means an agreement to exchange different currencies at a forward rate.

Forward rate is the specified exchange rate for exchange of two currencies at a specified future date.

'Foreign currency' is a currency other than the reporting currency of an enterprise.

3.3 INITIAL RECOGNITION

A foreign currency transaction should be recorded, on initial recognition in the reporting currency, by applying to the foreign currency amount the exchange rate between the reporting currency and the foreign currency at the date of the transaction.

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A rate that approximates the actual rate at the date of the transaction is often used. However, if exchange rates fluctuate significantly, the use of the average rate for a period is unreliable.

3.4 REPORTING AT EACH BALANCE SHEET DATE

The treatment of foreign currency items at the balance sheet date depends on whether the item is:

- monetary or non-monetary; and
- carried at historical cost or fair value (for non-monetary items).

  a. Foreign currency monetary items should be reported using the closing rate. However, in certain circumstances, the closing rate may not reflect with reasonable accuracy the amount in reporting currency that is likely to be realised from, or required to disburse, a foreign currency monetary item at the balance sheet date, e.g., where there are restrictions on remittances or where the closing rate is unrealistic and it is not possible to effect an exchange of currencies at that rate at the balance sheet date.

  b. Non-monetary items which are carried in terms of historical cost denominated in a foreign currency should be reported using the exchange rate at the date of the transaction.

  c. Non-monetary items which are carried at fair value or other similar valuation denominated in a foreign currency should be reported using the exchange rates that existed when the values were determined.

  d. The contingent liability denominated in foreign currency at the balance sheet date is disclosed by using the closing rate.

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3.5 RECOGNITION OF EXCHANGE DIFFERENCES

Exchange differences arising on the settlement of monetary items or on reporting an enterprise's monetary items at rates different from those at which they were initially recorded during the period, or reported in previous financial statements, should be recognised as income or as expenses in the period in which they arise.

An exchange difference results when there is a change in the exchange rate between the transaction date and the date of settlement of any monetary items arising from a foreign currency transaction. When the transaction is settled within the same accounting period as that in which it occurred, all the exchange difference is recognised in that period. However, when the transaction is settled in a subsequent accounting period, the exchange difference recognised in each intervening period up to the period of settlement is determined by the change in exchange rates during that period.

Note: Central Government in consultation with National Advisory Committee on Accounting Standards made an amendment to AS 11 "The Effects of Changes in Foreign Exchange Rates" in the form of Companies (Accounting Standards) Amendment Rules, 2009 and 2011.

Any difference pertaining to accounting periods which commenced on or after 7th December, 2006, previously, recognised in the profit and loss account before the exercise of the option should be reversed insofar as it relates to the acquisition of a depreciable capital asset by addition or deduction from the cost of the asset and in other cases by transfer to Foreign Currency Monetary Item Translation Difference (FCMITD) Account, and by debit or credit, as the case may be, to the general reserve.

If the above option is exercised, disclosure should be made of the fact of such exercise of such option and of the amount remaining to be amortised in the financial statements of the period in which such option is exercised and in every subsequent period so long as any exchange difference remains unamortised.

For the purposes of exercise of this option, an asset or liability should be designated as a long-term foreign currency monetary item, if the asset or liability is expressed in a foreign currency and has a term of 12 months or more at the date of origination of the asset or liability.

Further in December, 2011, the Ministry of Corporate Affairs inserted paragraph 46A in AS 11 of the Companies (Accounting Standards) Rules, 2006. According to it, in respect of accounting periods commencing on or after the 1st April, 2011, an enterprise which had earlier exercised the option under paragraph 46 and at the option of any other enterprise, the exchange differences arising on reporting of long-term foreign currency monetary items at rates different from those at which they were initially recorded during the period, or reported in previous financial statements, in so far as they relate to the acquisition of a depreciable capital assets, can be added to or deducted from the cost of the assets and should be depreciated over the balance life of the assets, and in other cases, can be accumulated in a "Foreign Currency Monetary Item Translation Difference Account" in the enterprise's financial statements and amortised over the balance period of such long term assets or liability, by recognition as income or expense in each of such periods.

Such option is irrevocable and should be applied to all such foreign currency monetary items. The enterprise exercising such option should disclose the fact of such option and of the amount remaining to be amortised in the financial statements of the period in which such option is exercised and in every subsequent period so long as any exchange difference remains unamortised.

3.6 CLASSIFICATION OF FOREIGN OPERATIONS AS INTEGRAL OR NON-INTEGRAL

The method used to translate the financial statements of a foreign operation depends on the way in which it is financed and operates in relation to the reporting enterprise. For this purpose, foreign operations are classified as either **'integral foreign operations' or 'non-integral foreign operations'**.

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An integral foreign operation carries on its business as if it were an extension of the reporting enterprise's operations. For example, such an operation might only sell goods imported from the reporting enterprise and remits the proceeds to the reporting enterprise. In such cases, a change in the exchange rate between the reporting currency and the currency in the country of foreign operation has an almost immediate effect on the reporting enterprise's cash flow from operations. Therefore, the change in the exchange rate affects the individual monetary items held by the foreign operation rather than the reporting enterprise's net investment in that operation.

In contrast, a non-integral foreign operation accumulates cash and other monetary items, incurs expenses, generates income and perhaps arranges borrowings, all substantially in its local currency. It may also enter into transactions in foreign currencies, including transactions in the reporting currency. When there is a change in the exchange rate between the reporting currency and the local currency, there is little or no direct effect on the present and future cash flows from operations of either the non-integral foreign operation or the reporting enterprise. The change in the exchange rate affects the reporting enterprise's net investment in the non-integral foreign operation rather than the individual monetary and non- monetary items held by the non-integral foreign operation.

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3.7 TRANSLATION OF FOREIGN INTEGRAL OPERATIONS

The individual items in the financial statements of the foreign operation are translated as if all its transactions had been entered into by the reporting enterprise itself. The cost and depreciation of tangible fixed assets is translated using the exchange rate at the date of purchase of the asset or, if the asset is carried at fair value or other similar valuation, using the rate that existed on the date of the valuation. The cost of inventories is translated at the exchange rates that existed when those costs were incurred. The recoverable amount or realisable value of an asset is translated using the exchange rate that existed when the recoverable amount or net realisable value was determined. For example, when the net realisable value of an item of inventory is determined in a foreign currency, that value is translated using the exchange rate at the date as at which the net realisable value is determined. The rate used is therefore usually the closing rate.

3.8 TRANSLATION OF NON-INTEGRAL FOREIGN OPERATIONS

The translation of the financial statements of a non-integral foreign operation is done using the following procedures:

a. The assets and liabilities, both monetary and non-monetary, of the non integral foreign operation should be translated at the closing rate;

b. Income and expense items of the non-integral foreign operation should be translated at exchange rates at the dates of the transactions; and

c. All resulting exchange differences should be accumulated in a foreign currency translation reserve until the disposal of the net investment.

d. For practical reasons, a rate that approximates the actual exchange rates, for example an average rate for the period is often used to translate income and expense items of a foreign operation.

e. Any goodwill or capital reserve arising on the acquisition of a non-integral foreign operation is translated at the closing rate.

f. A contingent liability disclosed in the financial statements of a non-integral foreign operation is translated at the closing rate for its disclosure in the financial statements of the reporting enterprise.

g. The incorporation of the financial statements of a non-integral foreign operation in those of the reporting enterprise follows normal consolidation procedures, such as the elimination of intra-group balances and intra-group transactions of a subsidiary. However, an exchange difference arising on an intra-group monetary item, whether short-term or long-term, cannot be eliminated against a corresponding amount arising on other intra-group balances because the monetary item represents a commitment to convert one currency into another and exposes the reporting enterprise to a gain or loss through currency fluctuations.

h. When the financial statements of a non-integral foreign operation are drawn up to a different reporting date from that of the reporting enterprise, the non-integral foreign operation often prepares, for purposes of incorporation in the financial statements of the reporting enterprise, statements as at the same date as the reporting enterprise (AS 21 (Revised).

i. The translation of the financial statements of a non-integral foreign operation results in the recognition of exchange differences arising from:

1. translating income and expense items at the exchange rates at the dates of transactions and assets and liabilities at the closing rate;
2. translating the opening net investment in the non-integral foreign operation at an exchange rate different from that at which it was previously reported; and
3. other changes to equity in the non-integral foreign operation.

These exchange differences are not recognised as income or expenses for the period because the changes in the exchange rates have little or no direct effect on the present and future cash flows from operations of either the non-integral foreign operation or the reporting enterprise. When a non-integral foreign operation is consolidated but is not wholly owned, accumulated exchange differences arising from translation and attributable to minority interests are allocated to, and reported as part of, the minority interest in the consolidated balance sheet.

j. On the disposal of a non-integral foreign operation, the cumulative amount of the exchange differences which have been deferred and which relate to that operation should be recognised as income or as expenses.

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k. An enterprise may dispose of its interest in a non-integral foreign operation through sale, liquidation, repayment of share capital, or abandonment of all, or part of, that operation. The payment of a dividend forms part of a disposal only when it constitutes a return of the investment. Remittance from a non-integral foreign operation by way of repatriation of accumulated profits does not form part of a disposal unless it constitutes return of the investment[€]. In the case of a partial disposal, only the proportionate share of the related accumulated exchange differences is included in the gain or loss. A write-down of the carrying amount of a non-integral foreign operation does not constitute a partial disposal. Accordingly, no part of the deferred foreign exchange gain or loss is recognized at the time of a write down".

[€] ***MCA amended this paragraph, by notification dated 18th June, 2018, which is relevant for companies.***

The following are indications that a foreign operation is a non-integral foreign operation rather than an integral foreign operation:

a. While the reporting enterprise may control the foreign operation, the activities of the foreign operation are carried out with a significant degree of autonomy from those of the reporting enterprise.

b. Transactions with the reporting enterprise are not a high proportion of the foreign operation's activities.

c. The activities of the foreign operation are financed mainly from its own operations or local borrowings rather than from the reporting enterprise.

d. Costs of labour, material and other components of the foreign operation's products or services are primarily paid or settled in the local currency rather than in the reporting currency.

e. The foreign operation's sales are mainly in currencies other than the reporting currency.

f. Cash flows of the reporting enterprise are insulated from the day-to-day activities of the foreign operation rather than being directly affected by the activities of the foreign operation.

g. Sales prices for the foreign operation’s products are not primarily responsive on a short-term basis to changes in exchange rates but are determined more by local competition or local government regulation.

h. There is an active local sales market for the foreign operation’s products, although there also might be significant amounts of exports.

(Refer Illustration 1 - 3)

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3.9 CHANGE IN THE CLASSIFICATION OF A FOREIGN OPERATION

When a foreign operation that is integral to the operations of the reporting enterprise is reclassified as a non-integral foreign operation, exchange differences arising on the translation of non-monetary assets at the date of the reclassification are accumulated in a foreign currency translation reserve. When a non-integral foreign operation is reclassified as an integral foreign operation, the translated amounts for non-monetary items at the date of the change are treated as the historical cost for those items in the period of change and subsequent periods. Exchange differences which have been deferred are not recognised as income or expenses until the disposal of the operation.

3.10 TAX EFFECTS OF EXCHANGE DIFFERENCES

Gains and losses on foreign currency transactions and exchange differences arising on the translation of the financial statements of foreign operations may have associated tax effects which are accounted for in accordance with AS 22.

3.11 FORWARD EXCHANGE CONTRACT

An enterprise may enter into a forward exchange contract or another financial instrument that is in substance a forward exchange contract, which is not intended for trading or speculation purposes, to establish the amount of the reporting currency required or available at the settlement date of a transaction. The premium or discount arising at the inception of such a forward exchange contract should be amortised as expense or income over the life of the contract.

Exchange differences on such a contract should be recognised in the statement of profit and loss in the reporting period in which the exchange rates change. Any profit or loss arising on cancellation or renewal of such a forward exchange contract should be recognised as income or as expense for the period.

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(Refer Illustration 4 - 7)

3.12 DISCLOSURE

An enterprise should disclose:

a. The amount of exchange differences included in the net profit or loss for the period.

b. Net exchange differences accumulated in foreign currency translation reserve as a separate component of shareholders' funds, and a reconciliation of the amount of such exchange differences at the beginning and end of the period.

When the reporting currency is different from the currency of the country in which the enterprise is domiciled, the reason for using a different currency should be disclosed. The reason for any change in the reporting currency should also be disclosed. When there is a change in the classification of a significant foreign operation, an enterprise should disclose:

a. The nature of the change in classification;

b. The reason for the change;

c. The impact of the change in classification on shareholders' funds; and

d. The impact on net profit or loss for each prior period presented had the change in classification occurred at the beginning of the earliest period presented.

3.13 PRESENTATION OF FOREIGN CURRENCY MONETARY ITEM TRANSLATION DIFFERENCE ACCOUNT (FCMITDA)

In the format of Schedule III to the Companies Act, 2013, no line item has been specified for the presentation of "Foreign Currency Monetary Item Translation Difference Account (FCMITDA)". Since the balance in FCMITDA represents foreign currency translation loss, it does not meet the above definition of 'asset' as it is neither a resource nor any future economic benefit would flow to the entity there from. Therefore, such balance cannot be reflected as an asset. Therefore, debit or credit balance in FCMITDA should be shown on the "Equity and Liabilities" side of the balance sheet under the head 'Reserves and Surplus' as a separate line item.

(Refer Illustration 8 & 9)

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ILLUSTRATIONS

Illustration 1

Classify the following items as monetary or non-monetary item:

Inventories

Trade Receivables

Investment in Equity shares

Property, Plant and Equipment.

Solution:

Inventories	Non-monetary
Trade receivables	Monetary
Investment in equity shares	Non-monetary
Property, Plant and Equipment	Non-monetary

Illustration 2

	Exchange Rate per $
Goods purchased on 1.1.20X1 for US $ 15,000	**Rs.75**
Exchange rate on 31.3.20X1	**Rs.74**
Date of actual payment 7.7.20X1	**Rs.73**

You are required to ascertain the loss/gain to be recognized for financial years ended 31st March, 20X1 and 31st March, 20X2 as per AS 11.

Solution

As per AS 11 on 'The Effects of Changes in Foreign Exchange Rates', all foreign currency transactions should be recorded by applying the exchange rate on the date of transactions. Thus, goods purchased on 1.1.20X1 and corresponding creditors would be recorded at Rs.11,25,000 (i.e., $15,000 × Rs.75)

According to the standard, at the balance sheet date all monetary transactions should be reported using the closing rate. Thus, creditors of US $15,000 on 31.3.20X1 will be reported at Rs.11,10,000 (i.e., $15,000 × Rs.74) and exchange profit of Rs.15,000 (i.e., 11,25,000 – 11,10,000) should be credited to Profit and Loss account in the year ended 31st March, 20X1.

On 7.7.20X1, creditors of $15,000 is paid at the rate of Rs.73. As per AS 11, exchange difference on settlement of the account should also be transferred to Profit and Loss account. Therefore, Rs.15,000 (i.e., 11,10,000 – 10,95,000) will be credited to Profit and Loss account in the year ended 31st March, 20X2.

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Illustration 3

Kalim Ltd. borrowed US$ 4,50,000 on 01/01/20X1, which will be repaid as on 31/07/20X1. Kalim Ltd. prepares financial statement ending on 31/03/20X1. Rate of exchange between reporting currency (INR) and foreign currency (USD) on different dates are as under:

01/01/20X1 1 US$ = Rs.48.00

31/03/20X1 1 US$ = Rs.49.00

31/07/20X1 1 US$ = Rs.49.50

Solution

Journal Entries in the Books of Kalim Ltd.

Date	Particulars		Rs.(Dr.)	Rs.(Cr.)
20X1				
Jan. 01	Bank Account (4,50,000 x 48)	Dr.	216,00,000	
	To Foreign Loan Account			216,00,000
March 31	Foreign Exchange Difference Account	Dr.	4,50,000	
	To Foreign Loan Account			4,50,000
	[4,50,000 x (49-48)]			
July 01	Foreign Exchange Difference Account	Dr.	2,25,000	
	[4,50,000 x (49.5-49)]			
	Foreign Loan Account	Dr.	220,50,000	
	To Bank Account			2,22,75,000

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Illustration 4

Rau Ltd. purchased a plant for US$ 1,00,000 on 01st February 20X1, payable after three months. Company entered into a forward contract for three months @ Rs.49.15 per dollar. Exchange rate per dollar on 01st Feb. was Rs.48.85. How will you recognise the profit or loss on forward contract in the books of Rau Ltd.?

Solution

Forward Rate	Rs.49.15
Less: Spot Rate	(Rs.48.85)
Premium on Contract	Rs.0.30
Contract Amount	US$ 1,00,000
Total Loss (1,00,000 x 0.30)	Rs.30,000

Contract period 3 months (2 months falling in the year ended 31st March, 20X1)

Loss to be recognised (30,000/3) x 2 = Rs.20,000 in the year ended 31st March, 20X1. Rest Rs.10,000 will be recognised in the following year.

In recording a forward exchange contract intended for trading or speculation purposes, the premium or discount on the contract is ignored and at each balance sheet date, the value of the contract is marked to its current market value and the gain or loss on the contract is recognised.

Illustration 5

Mr. A bought a forward contract for three months of US$ 1,00,000 on 1st December at 1 US$ = Rs.47.10 when exchange rate was US$ 1 = Rs.47.02. On 31st December when he closed his books exchange rate was US$ 1 = Rs.47.15. On 31st January, he decided to sell the contract at Rs.47.18 per dollar. Show how the profits from contract will be recognised in the books.

Solution

Since the forward contract was for speculation purpose the premium on contract i.e. the difference between the spot rate and contract rate will not be recorded in the books. Only when the contract is sold the difference between the contract rate and sale rate will be recorded in the Profit & Loss Account.

Sale Rate	Rs.47.18
Less: Contract Rate	(Rs.47.10)
Premium on Contract	Rs.0.08
Contract Amount	US$ 1,00,000
Total Profit (1,00,000 x 0.08)	Rs.8,000

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Illustration 6

Assets and liabilities and income and expenditure items in respect of foreign branches (integral foreign operations) are translated into Indian rupees at the prevailing rate of exchange at the end of the year. The resultant exchange differences in the case of profit, is carried to other Liabilities Account and the Loss, if any, is charged to the statement of profit and loss. Comment.

Solution

The financial statements of an integral foreign operation (for example, dependent foreign branches) should be translated using the principles and procedures described in AS 11. The individual items in the financial statements of a foreign operation are translated as if all its transactions had been entered into by the reporting enterprise itself.

Individual items in the financial statements of the foreign operation are translated at the actual rate on the date of transaction. For practical reasons, a rate that approximates the actual rate at the date of transaction is often used, for example, an average rate for a week or a month may be used for all transactions in each foreign currency during the period. The foreign currency monetary items (for example cash, receivables, payables) should be reported using the closing rate at each balance sheet date. Non-monetary items (for example, fixed assets, inventories, investments in equity shares) which are carried in terms of historical cost denominated in a foreign currency should be reported using the exchange date at the date of transaction. Thus the cost and depreciation of the tangible fixed assets is translated using the exchange rate at the date of purchase of the asset if asset is carried at cost. If the fixed asset is carried at fair value, translation should be done using the rate existed on the date of the valuation. The cost of inventories is translated at the exchange rates that existed when the cost of inventory was incurred and realizable value is translated applying exchange rate when realizable value is determined which is generally closing rate.

Exchange difference arising on the translation of the financial statements of integral foreign operation should be charged to profit and loss account. Exchange difference arising on the translation of the financial statement of foreign operation may have tax effect which should be dealt as per AS 22 'Accounting for Taxes on Income'.

Thus, the treatment by the management of translating all assets and liabilities; income and expenditure items in respect of foreign branches at the prevailing rate at the year end and also the treatment of resultant exchange difference is not in consonance with AS 11.

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Illustration 7

A business having the Head Office in Kolkata has a branch in UK. The following is the trial balance of Branch as at 31.03.20X4:

Account Name	**Amount in £**	
	Dr.	**Cr.**
Machinery (purchased on 01.04.20X1)	**5,000**	
Debtors	**1,600**	
Opening Stock	**400**	
Goods received from Head Office Account	**6,100**	
(Recorded in HO books as Rs.4,02,000)		
Sales		**20,000**
Purchases	**10,000**	

Wages	**1,000**	
Salaries	**1,200**	
Cash	**3,200**	
Remittances to Head Office (Recorded in HO books as Rs.1,91,000)	**2,900**	
Head Office Account (Recorded in HO books as Rs.4,90,000)		**7,400**
Creditors		**4,000**

- **Closing stock at branch is £ 700 on 31.03.20X4.**
- **Depreciation @ 10% p.a. is to be charged on Machinery.**
- **Prepare the trial balance after been converted in Indian Rupees.**
- **Exchange rates of Pounds on different dates are as follow: 01.04.20X1– Rs.61; 01.04.20X3– Rs.63 & 31.03.20X4 – Rs.67**

Solution

Trial Balance of the Foreign Branch converted into Indian Rupees as on March 31, 20X4

Particulars	£ (Dr.)	£ (Cr.)	Conversion Basis	Rs.(Dr.)	Rs.(Cr.)
Machinery	5,000		Transaction date rate	3,05,000	
Debtors	1,600		Closing Rate	1,07,200	
Opening Stock	400		Opening Rate	25,200	
Goods Received from HO	6,100		Actuals	4,02,000	
Sales		20,000	Average Rate		13,00,000
Purchases	10,000		Average Rate	6,50,000	
Wages	1,000		Average Rate	65,000	
Salaries	1,200		Average Rate	78,000	
Cash	3,200		Closing Rate	2,14,400	
Remittance to HO	2,900		Actuals	1,91,000	
HO Account		7,400	Actuals		4,90,000
Creditors		4,000	Closing Rate		2,68,000
Exchange Rate Difference			Balancing Figure	20,200	
	31,400	**31,400**		**20,58,000**	**20,58,000**
Closing Stock	700		Closing Rate	46,900	
Depreciation	500		Fixed Asset Rate	30,500	

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Illustration 8

A Ltd. purchased fixed assets costing Rs.3,000 lakhs on 1.1.20X1 and the same was fully financed by foreign currency loan (U.S. Dollars) payable in three annual equal instalments. Exchange rates were 1 Dollar = Rs.40.00 and Rs.42.50 as on 1.1.20X1 and 31.12.20X1 respectively. First instalment was paid on 31.12.20X1. The entire difference in foreign exchange has been capitalised.

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

Solution

As per AS 11 'The Effects of Changes in Foreign Exchange Rates', exchange differences arising on the settlement of monetary items or on reporting an enterprise's monetary items at rates different from those at which they were initially recorded during the period, or reported in previous financial statements, should be recognised as income or expenses in the period in which they arise. Thus exchange differences arising on repayment of liabilities incurred for the purpose of acquiring fixed assets are recognised as income or expense.

Calculation of Exchange Difference:

Foreign currency loan = $\frac{\text{Rs.3,000 lakhs}}{\text{Rs.40}}$ = 75 lakhs US Dollars

Exchange difference = 75 lakhs US Dollars × (42.50 – 40.00) = Rs. 187.50 lakhs

(Including exchange loss on payment of first instalment)

Therefore, entire loss due to exchange differences amounting Rs.187.50 lakhs should be charged to profit and loss account for the year.

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Note: The above answer has been given on the basis that the company has not exercised the option of capitalisation available under paragraph 46 of AS 11. However, if the company opts to avail the benefit given in paragraph 46A, then nothing is required to be done since the company has done the correct treatment.

Illustration 9

A Ltd. has borrowed USD 10,000 in foreign currency on April 1, 20X1 at 5% p.a. annual interest and acquired a depreciable asset. The exchange rates are as under:

01/04/20X1 1 US$ = Rs.48.00

31/03/20X2 1 US$ = Rs.51.00

You are required to pass the journal entries in the following cases:

i. **Option under Para 46A is not availed.**
ii. **Option under Para 46A is availed.**
iii. **The loan was taken to finance the operations of the entity (and not to procure a depreciable asset).**

In all cases, assume interest accrued on 31 March 20X2 is paid on the same date

Solution

Journal Entries in the Books of A Ltd.

i. Option under Para 46A is not availed

Date	Particulars		Rs.(Dr.)	Rs.(Cr.)
20X1				
Apr. 01	Bank Account (10,000 x 48)	Dr.	4,80,000	
	To Foreign Loan Account			4,80,000
Mar 31	Finance Cost (USD 10,000 x 5% x Rs.51)		25,500	
	To Bank Account 25,500			25,500
Mar 31	Foreign Exchange Difference Account (P/L)	Dr.	30,000	
	To Foreign Loan Account [10,000 x (51-48)]			30,000

In this case, since the option under Para 46A is **NOT** availed, the Exchange Loss of Rs.30,000 is recognised as an expense in the Statement of Profit and Loss for the year ending 31 March 20X2.

ii. Option under Para 46A is availed

Date	Particulars		Rs.(Dr.)	Rs.(Cr.)
20X1				
Apr. 01	Bank Account (10,000 x 48)	Dr.	4,80,000	
	To Foreign Loan Account			4,80,000
Mar 31	Finance Cost (USD 10,000 x 5% x Rs.51)		25,500	
	To Bank Account 25,500			25,500
Mar 31	Foreign Exchange Difference Account	Dr.	30,000	
	To Foreign Loan Account [10,000 x (51-48)]			30,000
Mar 31	Property, Plant and Equipment	Dr.	30,000	
	To Foreign Exchange Difference Account			30,000

In this case, since the option under Para 46A is availed, the Exchange Loss of Rs.30,000 is capitalized in the cost of Property, Plant and Equipment, which will indirectly get recognized in the Profit & Loss A/c by way of increased depreciation over the remaining useful life of the asset.

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iii. Option under Para 46A is availed

Date	Particulars		Rs.(Dr.)	Rs.(Cr.)
20X1				
Apr. 01	Bank Account (10,000 x 48)	Dr.	4,80,000	
	To Foreign Loan Account			4,80,000
Mar 31	Finance Cost (USD 10,000 x 5% x Rs.51)		25,500	
	To Bank Account 25,500			25,500
Mar 31	Foreign Exchange Difference Account	Dr.	30,000	
	To Foreign Loan Account [10,000 x (51-48)]			30,000
Mar 31	Foreign Currency Monetary Item Translation Difference A/c (FCMITDA)	Dr.	30,000	
	To Foreign Exchange Difference Account			30,000

In this case, since the option under Para 46A is availed, the Exchange Loss of Rs.30,000 is accumulated in the FCMITD A/c, which will be subsequently spread over and debited to P&L A/c over the tenure of the loan.

Reference: The students are advised to refer the full text of AS 11 "The Effects of Changes in Foreign Exchange Rates".

SHRESHTA

TEST YOUR KNOWLEDGE

MCQs

1. **As per AS 11 assets and liabilities of non-integral foreign operations should be converted at __________ rate.**
    a. **Opening**
    b. **Average**
    c. **Closing**
    d. **Transaction**

2. **The debit or credit balance of "Foreign Currency Monetary Item Translation Difference Account"**
    a. **Is shown as "Miscellaneous Expenditure" in the Balance Sheet**
    b. **Is shown under "Reserves and Surplus" as a separate line item**
    c. **Is shown as "Other Non-current" in the Balance Sheet**
    d. **Is shown as "Current Assets" in the Balance Sheet**

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3. **If asset of an integral foreign operation is carried at cost, cost and depreciation of tangible fixed asset is translated at**
    a. **Average exchange rate**
    b. **Closing exchange rate**
    c. **Exchange rate at the date of purchase of asset**
    d. **Opening exchange rate**

4. **Which of the following can be classified as an integral foreign operation?**
    a. **Branch office serving as an extension of the head office in terms of operations**
    b. **Independent subsidiary of the parent company**
    c. **Branch office independent of the head office in terms of operational decisions**
    d. **None of the above**

5. **Which of the following items should be converted to closing rate for the purposes of financial reporting?**
    a. **Items of Property, Plant and Equipment**
    b. **Inventory**
    c. **Trade Payables, Trade Receivables and Foreign Currency Borrowings**
    d. **All of the above**

ANSWERS/SOLUTION

MCQs

1.	**c.**	Closing
2.	**b.**	Is shown under "Reserves and Surplus" as a separate line item
3.	**c.**	Exchange rate at the date of purchase of asset
4.	**a.**	Branch office serving as an extension of the head office in terms of operations
5.	**c.**	Trade Payables, Trade Receivables and Foreign Currency Borrowings

THEORY QUESTIONS

Q.NO.1. Explain "monetary item" as per Accounting Standard 11. How are foreign currency monetary items to be recognized at each Balance Sheet date?

ANSWER

As per AS 11 'The Effects of Changes in Foreign Exchange Rates', Monetary items are money held and assets and liabilities to be received or paid in fixed or determinable amounts of money.

Foreign currency monetary items should be reported using the closing rate at each balance sheet date. However, in certain circumstances, the closing rate may not reflect with reasonable accuracy the amount in reporting currency that is likely to be realized from, or required to disburse, a foreign currency monetary item at the balance sheet date. In such circumstances, the relevant monetary item should be reported in the reporting currency at the amount which is likely to be realized from or required to disburse, such item at the balance sheet date.

Q.NO.2. Distinguish Non-Integral Foreign Operation (NFO) with Integral Foreign Operation (IFO) as per AS 11.

ANSWER

As per AS 11, Integral foreign operation (IFO) is a foreign operation, the activities of which are an integral part of those of the reporting enterprise. A foreign operation that is integral to the operations of the reporting enterprise carries on its business as if it were an extension of the reporting enterprise's operations. In contrast, a non-integral foreign operation (NFO) is a foreign operation that is not an integral operation. For details, refer para 2.5 of chapter.

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PRACTICAL QUESTIONS

Q.NO.1. Explain briefly the accounting treatment needed in the following cases as per AS 11 as on 31.3. 20X1.

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

Long term loan taken from a U.S. Company, amounting to Rs.60,00,000. It was recorded at US $ 1 = Rs.55.60, taking exchange rate prevailing at the date of transaction. US $ 1 = Rs. 61.20 was on 31.3. 20X1.

SOLUTION

As per AS 11 "The Effects of Changes in Foreign Exchange Rates", exchange differences arising on the settlement of monetary items or on reporting an enterprise's monetary items at rates different from those at which they were initially recorded during the period, or reported in previous financial statements, should be recognised as income or as expenses in the period in which they arise. However, at the option of an entity, exchange differences arising on reporting of long-term foreign currency monetary items at rates different from those at which they were initially recorded during the period, or reported in previous financial statements, in so far as they relate to the acquisition of a depreciable capital asset can be added to or deducted from the cost of the asset and should be depreciated over the balance life of the asset, and in other cases, can be accumulated in a "Foreign Currency Monetary Item Translation Difference Account" in the enterprise's financial statements and amortised over the balance period of such long-term asset/ liability, by recognition as income or expense in each of such periods.

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Trade receivables	Foreign Currency Rate	Rs.
Initial recognition US $8,547 (5,00,000/58.50)	1 US $ = Rs.58.50	5,00,000
Rate on Balance sheet date	1 US $ = Rs.61.20	
Exchange Difference Gain US $ 8,547 x (61.20-58.50)		23,077
Treatment: Credit Profit and Loss A/c by Rs.23,077		
Long term Loan		
Initial recognition US $ 1,07,913.67 (60,00,000/55.60)	1 US $ = Rs.55.60	60,00,000
Rate on Balance sheet date	1 US $ = Rs.61.20	
Exchange Difference Loss US $ 1,07,913.67 x (61.20 – 55.60)		6,04,317

Treatment: Credit Loan A/c And Debit FCMITD A/C or Profit and Loss A/c by Rs.6,04,317		

Thus Exchange Difference on Long term loan amounting Rs.6,04,317 may either be charged to Profit and Loss A/c or to Foreign Currency Monetary Item Translation Difference Account but exchange difference on debtors amounting Rs.23,077 is required to be transferred to Profit and Loss A/c.

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UNIT 4: ACCOUNTING STANDARD 22: ACCOUNTING FOR TAXES ON INCOME

LEARNING OUTCOMES

After studying this chapter, you will be able to comprehend the:

- What is the Objective of AS 22
- What is the Recognition criteria for Deferred Tax
- Re-assessment of Unrecognised Deferred Tax Assets
- Measurement of Deferred Tax
- Review of Deferred Tax Assets
- Presentation and Disclosure
- Solve the practical problems based on application of Accounting Standards.

4.1 INTRODUCTION

This standard prescribes the accounting treatment of taxes on income and follows the concept of matching expenses against revenue for the period. The concept of matching is more peculiar in cases of income taxes since in a number of cases, the taxable income may be significantly different from the income reported in the financial statements due to the difference in treatment of certain items under taxation laws and the way it is reflected in accounts.

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4.2 OBJECTIVE

Matching of such taxes against revenue for a period poses special problems arising from the fact that in a number of cases, taxable income may be significantly different from the accounting income. This divergence between taxable income and accounting income arises due to two main reasons.

Firstly, there are differences between items of revenue and expenses as appearing in the statement of profit and loss and the items which are considered as revenue, expenses or deductions for tax purposes.

Secondly, there are differences between the amount in respect of a particular item of revenue or expense as recognised in the statement of profit and loss and the corresponding amount which is recognised for the computation of taxable income.

4.3 DEFINITIONS

Accounting income (loss) is the net profit or loss for a period, as reported in the statement of profit and loss, before deducting income-tax expense or adding income tax saving.

Taxable income (tax loss) is the amount of the income (loss) for a period, determined in accordance with the tax laws, based upon which income-tax payable (recoverable) is determined.

Tax expense (tax saving) is the aggregate of current tax and deferred tax charged or credited to the statement of profit and loss for the period.

Current Tax + Deferred Tax = Tax expense (Tax saving)

Current tax is the amount of income tax determined to be payable (recoverable) in respect of the taxable income (tax loss) for a period.

Deferred tax is the tax effect of timing differences.

The differences between taxable income and accounting income can be classified into permanent differences and timing differences.

Timing differences are the differences between taxable income and accounting income for a period that originate in one period and are capable of reversal in one or more subsequent periods.

For example, machinery purchased for scientific research related to business is fully allowed as deduction in the first year for tax purposes whereas the same would be charged to the statement of profit and loss as depreciation over its useful life. The total depreciation charged on the machinery for accounting purposes and the amount allowed as deduction for tax purposes will ultimately be the same, but periods over which the depreciation is charged and the deduction is allowed will differ. This may lead to recognition of deferred tax in the books.

Permanent differences are the differences between taxable income and accounting income for a period that originate in one period and do not reverse subsequently. Generally permanent differences lead to increase in current tax & have no impact on Deferred Tax.

For Example, XYZ has been charged with the fine on the late payment of the tax amount due to authorities. This would be considered as an expense in the profit and loss account; however, this is specifically a disallowed expense for computation of taxable income. This will be treated as permanent difference as this difference will never reverse.

4.4 RECOGNITION

Tax expense for the period, comprising current tax and deferred tax, should be included in the determination of the net profit or loss for the period.

Taxes on income are considered to be an expense incurred by the enterprise in earning income and are accrued in the same period as the revenue and expenses to which they relate. Such matching may result into timing differences. The tax effects of timing differences are included in the tax expense in the statement of profit and loss and as deferred tax assets or as deferred tax liabilities, in the balance sheet.

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While recognising the tax effect of timing differences, consideration of prudence cannot be ignored. Therefore, deferred tax assets are recognised and carried forward only to the extent that there is a reasonable certainty of their realisation.

This reasonable level of certainty would normally be achieved by examining the past record of the enterprise and by making realistic estimates of profits for the future. Where an enterprise has unabsorbed depreciation or carry forward of losses under tax laws, deferred tax assets should be recognised only to the extent that there is virtual certainty supported by convincing evidence that sufficient future taxable income will be available against which such deferred tax assets can be realised.

Permanent differences do not result in deferred tax assets or deferred tax liabilities.

4.5 MEASUREMENT

Current tax should be measured at the amount expected to be paid to (recovered from) the taxation authorities, using the applicable tax rates and tax laws.

Deferred tax assets and liabilities are usually measured using the tax rates and tax laws that have been enacted by the balance sheet date.

However, certain announcements of tax rates and tax laws by the government may have the substantive effect of actual enactment. In these circumstances, deferred tax assets and liabilities are measured using such announced tax rate and tax laws.

Deferred tax assets and liabilities should not be discounted to their present value.

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4.6 RE-ASSESSMENT OF UNRECOGNISED DEFERRED TAX ASSETS

At each balance sheet date, an enterprise re-assesses unrecognised deferred tax assets. The enterprise recognises previously unrecognised deferred tax assets to the extent that it has become reasonably certain or virtually certain, as the case may be, that sufficient future taxable income will be available against which such deferred tax assets can be realised.

4.7 REVIEW OF PREVIOUSLY RECOGNISED DEFERRED TAX ASSETS

The carrying amount of deferred tax assets should be reviewed at each balance sheet date. An enterprise should write-down the carrying amount of a deferred tax asset to the extent that it is no longer reasonably certain or virtually certain, as the case may be, that sufficient future taxable income will not be available against which deferred tax asset can be realised. Any such write-down may be reversed to the extent that it becomes reasonably certain or virtually certain, as the case may be, that sufficient future taxable income will be available.

4.8 Virtual certainty supported by CONVINCING EVIDENCE

Determination of virtual certainty that sufficient future taxable income will be available is a matter of judgement and will have to be evaluated on a case-to case basis. **Virtual certainty refers to the extent of certainty, which, for all practical purposes, can be considered certain.** Virtual certainty cannot be based merely on forecasts of performance such as business plans. Virtual certainty is not a matter of perception and it should be supported by convincing evidence. Evidence is a matter of fact. To be convincing, the evidence should be available at the reporting date in a concrete form, for example, a profitable binding export order, cancellation of which will result in payment of heavy damages by the defaulting party. On the other hand, a projection of the future profits made by an enterprise based on the future capital expenditures or future restructuring etc., submitted even to an outside agency, e.g., to a credit agency for obtaining loans and accepted by that agency cannot, in isolation, be considered as convincing evidence.

4.9 DISCLOSURE

Statement of profit and loss

Under AS 22, there is no specific requirement to disclose current tax and deferred tax in the statement of profit and loss. However, considering the requirements under the Companies Act, 2013, the amount of income tax and other taxes on profits should be disclosed.

AS 22 does not require any reconciliation between accounting profit and the tax expense.

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Balance sheet

The break-up of deferred tax assets and deferred tax liabilities into major components of the respective balance should be disclosed in the notes to accounts.

Deferred tax assets and liabilities should be distinguished from assets and liabilities representing current tax for the period. Deferred tax assets and liabilities should be disclosed under a separate heading in the balance sheet of the enterprise, separately from current assets and current liabilities.

The nature of the evidence supporting the recognition of deferred tax assets should be disclosed, if an enterprise has unabsorbed depreciation or carry forward of losses under tax laws.

An enterprise should offset assets and liabilities representing current tax if the enterprise:

a. Has a legally enforceable right to set off the recognised amounts and

b. Intends to settle the asset and the liability on a net basis.

An enterprise should offset deferred tax assets and deferred tax liabilities if:

a. The enterprise has a legally enforceable right to set off assets against liabilities representing current tax; and

b. The deferred tax assets and the deferred tax liabilities relate to taxes on income levied by the same governing taxation laws.

4.10 RELEVANT EXPLANATIONS TO AS 22

Accounting for Taxes on Income in the situations of Tax Holiday under sections 80-IA and 80-IB of the Income Tax Act, 1961

The deferred tax in respect of timing differences which reverse during the tax holiday period should not be recognised to the extent the enterprise's gross total income is subject to the deduction during the tax holiday period as per the requirements of the Act. Deferred tax in respect of timing differences which reverse after the tax holiday period should be recognised in the year in which the timing differences originate. However, recognition of deferred tax assets should be subject to the consideration of prudence as laid down in AS 22.

For the above purposes, the timing differences which originate first should be considered to reverse first.

Accounting for Taxes on Income in the situations of Tax Holiday under sections 10A and 10B of the Income Tax Act, 1961

The deferred tax in respect of timing differences which originate during the tax holiday period and reverse during the tax holiday period, should not be recognised to the extent deduction from the total income of an enterprise is allowed during the tax holiday period as per the provisions of sections 10A and 10B of the Act. Deferred tax in respect of timing differences which originate during the tax holiday period but reverse after the tax holiday period should be recognised in the year in which the timing differences originate. However, recognition of deferred tax assets should be subject to the consideration of prudence as laid down in AS 22.

Accounting for Taxes on Income in the context of section 115JB of the Income Tax Act, 1961

The payment of tax under section 115JB of the Act is a current tax for the period. In a period in which a company pays tax under section 115JB of the Act, the deferred tax assets and liabilities in respect of timing differences arising during the period, tax effect of which is required to be recognised under AS 22, should be measured using the regular tax rates and not the tax rate under section 115JB of the Act. In case an enterprise expects that the timing differences arising in the current period would reverse in a period in which it may pay tax under section 115JB of the Act, the deferred tax assets and liabilities in respect of timing differences arising during the current period, tax effect of which is required to be recognised under AS 22, should be measured using the regular tax rates and not the tax rate under section 115JB of the Act.

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ILLUSTRATIONS

Illustration 1

Rama Ltd., has provided the following information:

	Rs.
Depreciation as per accounting records	**= 2,00,000**
Depreciation as per income tax records	**= 5,00,000**
Unamortised preliminary expenses as per tax record	**= 30,000**

There is adequate evidence of future profit sufficiency. How much net deferred tax asset/liability should be recognised as transition adjustment? Tax rate 50%.

Solution

Table showing calculation of deferred tax asset / liability

Particulars	Amount	Timing differences	Deferred tax	Amount @ 50%
	Rs.			Rs.
Excess depreciation as per tax records (Rs.5,00,000 – Rs.2,00,000)	3,00,000	Timing	Deferred tax liability	1,50,000
Unamortised preliminary expenses as per tax records	30,000	Timing	Deferred tax asset	(15,000)
Net deferred tax liability				1,35,000

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Illustration 2

From the following details of A Ltd. for the year ended 31-03-20X1, calculate the deferred tax asset/ liability as per AS 22 and amount of tax to be debited to the Profit and Loss Account for the year.

Solution

Particulars	Rs.
Accounting Profit	**6,00,000**
Book Profit as per MAT	**3,50,000**
Profit as per Income Tax Act	**60,000**
Tax rate	**20%**
MAT rate	**7.50%**

Solution

Tax as per accounting profit 6,00,000×20% = Rs.1,20,000

Tax as per Income-tax Profit 60,000×20% = Rs.12,000

Tax as per MAT 3,50,000×7.50% = Rs.26,250

Tax expense= Current Tax +Deferred Tax

Rs.1,20,000 = Rs.12,000+ Deferred tax

Therefore, Deferred Tax liability as on 31-03-20X1

= Rs.1,20,000 – Rs.12,000 = Rs.1,08,000

Amount of tax to be debited in Profit and Loss account for the year 31-03-20X1

Current Tax + Deferred Tax liability + Excess of MAT over current tax

= Rs.12,000 + Rs.1,08,000 + Rs.14,250 (26,250 – 12,000) = Rs.1,34,250

Illustration 3

PQR Ltd.'s accounting year ends on 31st March. The company made a loss of Rs.2,00,000 for the year ending 31.3.20X1. For the years ending 31.3.20X2 and 31.3.20X3, it made profits of Rs.1,00,000 and Rs.1,20,000 respectively. It is assumed that the loss of a year can be carried forward for eight years and tax rate is 40%. By the end of 31.3.20X1, the company feels that there will be sufficient taxable income in the future years against which carry forward loss can be set off. There is no difference between taxable income and accounting income except that the carry forward loss is allowed in the years ending 20X2 and 20X3 for tax purposes. Prepare a statement of Profit and Loss for the years ending 20X1, 20X2 and 20X3.

Solution

Statement of Profit and Loss

	31.3.20X1 Rs.	31.3.20X2 Rs.	31.3.20X3 Rs.
Profit (Loss)	(2,00,000)	1,00,000	1,20,000
Less: Current tax (20,000 x 40%)			(8,000)
Deferred tax:			
Tax effect of timing differences originating during the year (2,00,000 x 40%)	80,000		
Tax effect of timing differences reversed/adjusted during the year (1,00,000 x 40%)		(40,000)	(40,000)
Profit (Loss) After Tax Effect	(1,20,000)	60,000	72,000

Illustration 4

Omega Limited is working on different projects which are likely to be completed within 3 years period. It recognises revenue from these contracts on percentage of completion method for financial statements during 20X0-20X1, 20X1-20X2 and 20X2-20X3 for Rs.11,00,000, Rs.16,00,000 and Rs.21,00,000 respectively. However, for Income-tax purpose, it has adopted the completed contract method under which it has recognised revenue of Rs.7,00,000, Rs.18,00,000 and Rs.23,00,000 for the years 20X0-20X1, 20X1-20X2 and 20X2-20X3 respectively. Income-tax rate is 35%. Compute the amount of deferred tax asset/liability for the years 20X0-20X1, 20X1- 20X2 and 20X2-20X3.

Solution

Calculation of Deferred Tax Asset/Liability in Omega Limited

Year	Accounting Income	Taxable Income	Timing Difference	Timing Difference (balance)	Deferred Tax	Deferred Tax Liability (balance)
20X0- 20X1	11,00,000	7,00,000	4,00,000	4,00,000	1,40,000	1,40,000
20X1- 20X2	16,00,000	18,00,000	(2,00,000)	2,00,000	(70,000)	70,000
20X2- 20X3	21,00,000	23,00,000	(2,00,000)	NIL	(70,000)	NIL
	48,00,000	48,00,000				

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Reference: The students are advised to refer the full text of AS 22 “Accounting for Taxes on Income”

TEST YOUR KNOWLEDGE

MCQs

1. **As per AS 22 on 'Accounting for Taxes on Income', tax expense is:**
    a. **Current tax + deferred tax charged to profit and loss account**
    b. **Current tax-deferred tax credited to profit and loss account**
    c. **Either a. or b.**
    d. **Deferred tax charged to profit and loss account**

2. **G Ltd. has provided the following information:**
   Depreciation as per accounting records = Rs.2,00,000
   Depreciation as per tax records = Rs.5,00,000
   There is adequate evidence of future profit sufficiency.
   How much deferred tax asset/liability should be recognized as transition adjustment when the tax rate is 50%?
    a. **Deferred Tax asset = Rs.2,70,000.**
    b. **Deferred Tax asset = Rs.1,35,000.**
    c. **Deferred Tax Liability = Rs.2,70,000**
    d. **Deferred Tax Liability = Rs.1,35,000.**

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3. **State which of the followings statements are correct:**
    1. **There are no pre-conditions required to recognize deferred tax liability,**
    2. **Deferred tax asset under all circumstances can only be created if and only if there is reasonable certainty that future taxable income will arise.**
    a. **Both are correct.**
    b. **Only 1 is correct.**
    c. **Only 2 is correct.**
    d. **None of the statements are correct.**

4. **Which of the following statement are incorrect:**
    a. **Only timing differences result in creation of deferred tax.**
    b. **Permanent differences do not result in recognition of deferred tax.**
    c. **The tax rate used for measurement of deferred tax is substantively enacted tax rate.**
    d. **The entity has to recognize deferred tax liability/asset arising out of timing difference. There are no conditions which are required to evaluated for their recognition.**

ANSWERS/SOLUTIONS

MCQs

1.	**c.**	Either a. or b.
2.	**d.**	Deferred Tax Liability = Rs.1,35,000.
3.	**a.**	Both are correct.
4.	**d.**	The entity has to recognize deferred tax liability/asset arising out of timing difference. There are no conditions which are required to evaluated for their recognition.

THEORETICAL QUESTIONS

Q.NO.1. Write short note on Timing differences and Permanent differences as per AS 22.

ANSWER

In current practices, companies, in general, prepare books of accounts as per Companies Act, 2013 generating Accounting Profit/Loss and Income-tax Act, 1961 generating Taxable Profit/Loss. Accounting income and taxable income for a period are seldom the same. Permanent differences are those which arise in one period and do not reverse subsequently. For e.g., an income exempt from tax or an expense that is not allowable as a deduction for tax purposes. Timing differences are those which arise in one period and are capable of reversal in one or more subsequent periods. For e.g., Depreciation etc.

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PRACTICAL QUESTIONS

Q.NO.1. Y Ltd. is a full tax free enterprise for the first ten years of its existence and is in the second year of its operation. Depreciation timing difference is INR 200 lakhs and INR 400 lakhs respectively which will result in a tax liability in year 1 and 2. From the third year it is expected that the timing difference would reverse each year by INR 10 lakhs. Assuming tax rate of 40%, find out the deferred tax liability at the end of the second year and any charge to the Profit and Loss account.

SOLUTION

As per AS 22, 'Accounting for Taxes on Income', deferred tax in respect of timing differences which originate during the tax holiday period and reverse during the tax holiday period, should not be recognised to the extent deduction from the total income of an enterprise is allowed during the tax holiday period as per the provisions of sections 10A and 10B of the Income tax Act. Deferred tax in respect of timing differences which originate during the tax holiday period but reverse after the tax holiday period should be recognised in the year in which the timing differences originate. However, recognition of deferred tax assets should be subject to the consideration of prudence. For this purpose, the timing differences which originate first should be considered to reverse first.

Out of 200 lakhs timing difference due to depreciation, difference amounting 80 lakhs (10 lakhs x 8 years) will reverse in the tax holiday period and therefore, should not be recognised. However, for 120 lakhs (200 lakhs – Rs.80 lakhs), deferred tax liability will be recognised for 48 lakhs (40% of 120 lakhs) in first year. In the second year, the entire amount of timing difference of Rs.400 lakhs will reverse only after tax holiday period and hence, will be recognised in full. Deferred tax liability amounting 160 lakhs (40% of 400 lakhs) will be created by charging it to profit and loss account and the total balance of deferred tax liability account at the end of second year will be 208 lakhs (48 lakhs + 160 lakhs).

Q.NO.2. Ultra Ltd. has provided the following information:

Depreciation as per accounting records =INR 4,00,000

Depreciation as per tax records =INR 10,00,000

Unamortized preliminary expenses as per tax record = INR 30,000

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

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SOLUTION

Calculation of difference between taxable income and accounting income

Particulars	Amount (Rs.)
Excess depreciation as per tax Rs.(10,00,000 – 4,00,000)	6,00,000
Less: Expenses unamortized in tax records	(30,000)
Timing difference	5,70,000

Tax expense is more than the current tax due to timing difference.

Therefore, deferred tax liability = 50% x 5,70,000 = 2,85,000

Q.NO.3. Saras Ltd. closes its books as on 31st March 20X2. They have accrued Rs.5,00,000 towards GST Liability for the month of March 20X2 by debiting their Profit and loss statement which is expected to be paid off by 21st April 20X2 . As per the provisions of Section 43B of the Income Tax Act, 1961 – Any expenditure of the nature mentioned in section 43B (e.g. taxes, duty, cess, fees, etc.) accrued in the statement of profit and loss on mercantile basis will be allowed for tax purposes in subsequent years on payment basis only. Assuming a Tax rate of 30% determine the Deferred Tax Asset/Liability as at 31st March 20X2.

SOLUTION

Calculation of difference between taxable income and accounting income

Particulars	Amount (Rs.)
GST Liability debited in books	5,00,000
Less: GST Liability allowed under Income Tax Act (Section 43B)	Nil
Timing difference	5,00,000

Tax expense is less than the current tax due to timing difference.

Therefore, deferred tax Asset = 30% x 5,00,000 = 1,50,000

Q.NO.4. ABC Company limited had an investment in Venture Capital amounting Rs.10 Crores. Venture capital in turn had invested in the below portfolio companies (New Start- ups) on behalf of ABC Limited:

Portfolio Companies	Amount of investment (Rs.in Crores)
Oscar Limited	**2**
Zee Limited	**3**
Star Limited	**4**

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Sony Limited	1
Total	**10**

During the FY 2019-2020, Venture Capital had sold their investment in Star Limited and realised an amount of Rs.8 Crores on sale of shares of star Limited and entire proceeds of Rs.8 Crores have been transferred by Venture Capital to ABC Company Limited.

The accounts manager has received the following additional information from venture capital on 31.03.2020:

1. **8 Crores has been deducted from the cost of investment and carrying amount of investment as at year end is 2 Crores.**
2. **Company had to pay a capital gain tax @ 20% on the net sale consideration of Rs.4 Crores.**
3. **Due to COVID-19, the remaining start- ups (i.e. Oscar Limited, Zee Limited, and Sony Limited) are not performing well and will soon wind up their operations. Venture capital is monitoring the situation and if required they will provide an impairment loss in June 2020 Quarter.**

You need to suggest the accounts manager what should be the correct accounting treatment as per AS 22 "Accounting for Taxes on Income".

SOLUTION

As company had to pay capital gain tax @ 20% on the net sale consideration as per income tax laws, the company has to recognise a current tax liability of 0.8 Crores computed as under:

Particulars	Amount of (Rs.in Crores)
Sales Consideration	8
Cost of Investment	4
Net gain on Sale	4
Tax @ 20%	0.8

As per AS 22, Timing differences are those differences between taxable income and accounting income for a period that originate in one period and are capable of reversal in one or more subsequent periods.

Particulars	Amount of (Rs.in Crores)	Rationale
Taxable Income	4	As per income tax laws
Accounting Income	Nil	As the same is deducted from the cost of investment
Timing Difference	4	

As per AS 22, deferred tax assets should be recognised and carried forward only to the extent that there is a reasonable certainty that sufficient future taxable income will be available against which such deferred tax assets can be realised.

Since in current scenario, due to Covid 19 the portfolio companies are not performing well, thus the company may not have sufficient future taxable income which will reverse deferred tax assets. Therefore, the company should not recognise DTA of Rs.0.8 Crores and company should recognise only current tax liability of Rs.0.8 Crores.

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8. REVENUE BASED ACCOUNTING STANDARDS

UNIT 1: ACCOUNTING STANDARD 7: CONSTRUCTION CONTRACTS

LEARNING OUTCOMES

After studying this unit, you will be able to comprehend the provisions of AS 7 related with:

- Introduction and Scope of Construction Contract
- Combining and Segmenting Construction Contracts
- What is included in Contract Revenue
- What is included and excluded in Contract Costs
- Recognition of Contract Revenue and Expenses
- Recognition of Expected Losses
- Changes in Estimates
- Disclosures.

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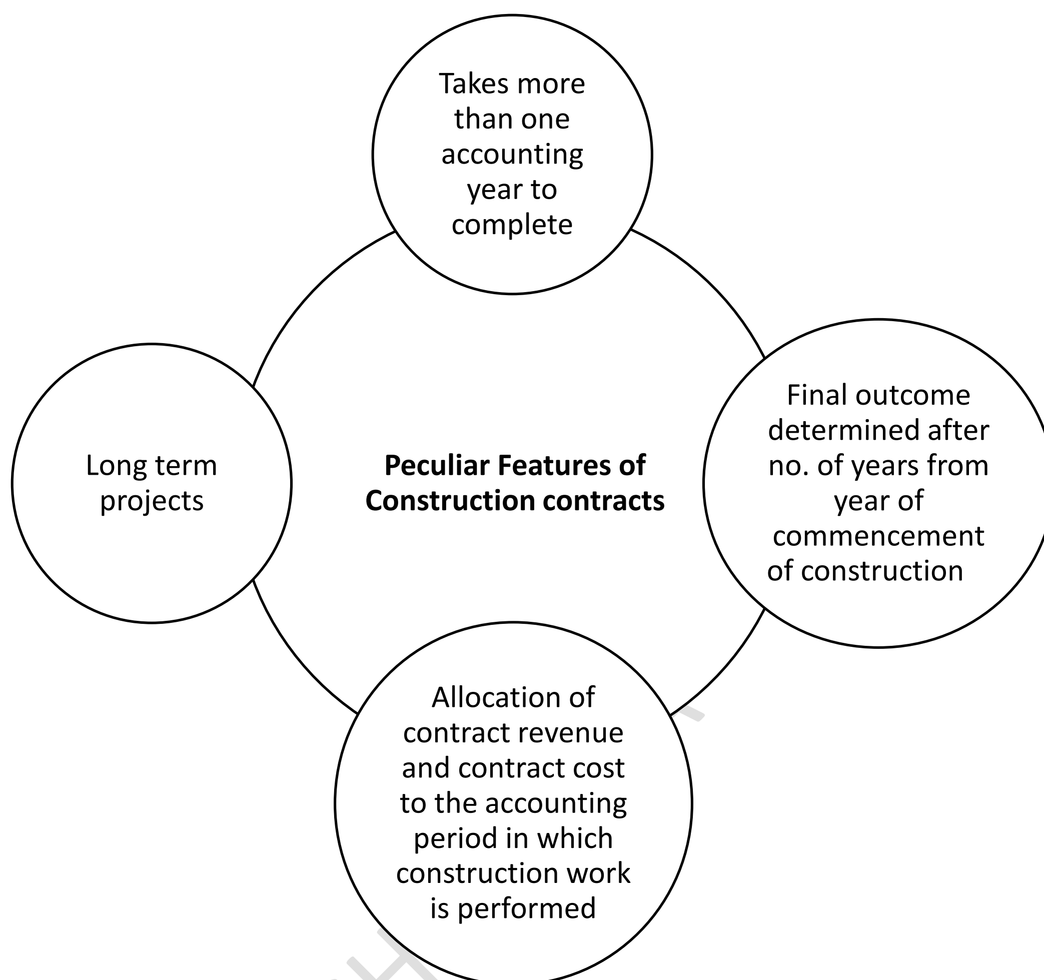
1.1 SIGNIFICANCE OF THE STANDARD

The need to have a standard for construction contracts and their accounting arises since the construction contracts generally cover more than one accounting period. Common examples of construction include construction of flyovers, dams, metro line, buildings etc. For example, if entity XY submits a tender to construct a flyover for a state government, the construction of that flyover might take 2 to 3 years of time, depending on the scope of the contract. This standard addresses the requirements for recognition & measurement (i.e., the timing and amount) of construction revenue and construction costs.

The entity that is required to complete the construction is referred to as **Contractor** and the customer who requires the construction to be completed is referred to as **Contractee/Customer.**



The above discussion clearly indicates that there are two parties to the construction contract. Thus, if there is an entity which requires its engineering division to construct a machine for the production division, this would not meet the scope of AS 7. It will be addressed by AS 10 (Property, plant and equipment) and will be accounted as a case of self-constructed asset.

1.2 INTRODUCTION

Accounting Standard 7 prescribes the principles of accounting for construction contracts in the **financial statements of contractors.** The focus of the standard is to determine when the contractor should recognise contract revenue and contract costs in the statement of profit and loss.

A construction contract is a contract specifically negotiated for the construction of an asset or a combination of assets that are closely interrelated or interdependent in terms of their design, technology and function or their ultimate purpose or use.

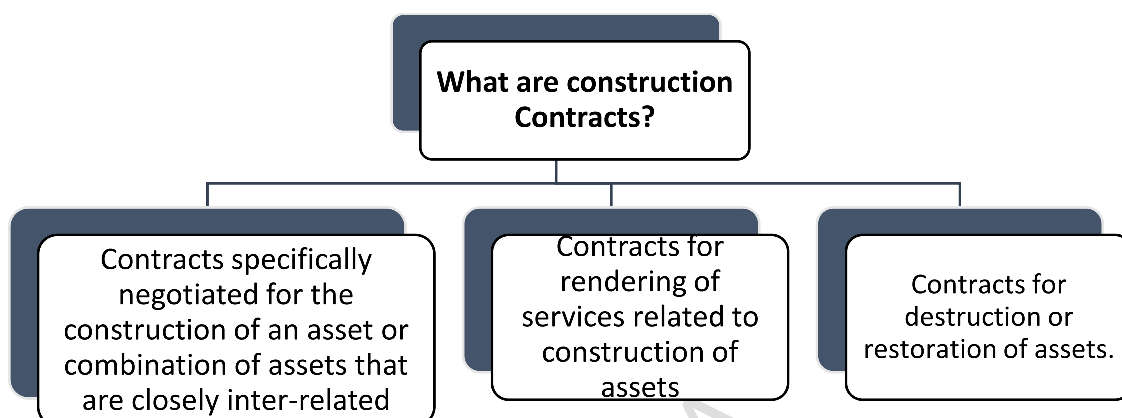
A construction contract may be negotiated for the construction of a single asset such as a bridge, building, dam, pipeline, road, ship or tunnel. A construction contract may also deal with the construction of a number of assets which are closely interrelated or interdependent in terms of their

design, technology and function or their ultimate purpose or use; examples of such contracts include those for the construction of refineries and other complex pieces of plant or equipment.

For the purposes of this Standard, construction contracts also include:

a. contracts for the rendering of services which are directly related to the construction of the asset, for example, those for the services of project managers and architects; and

b. contracts for destruction or restoration of assets, and the restoration of the environment following the demolition of assets.



Example 1

Entity XY contracts with AB to construct 2 residential buildings in the same premises. The construction of both buildings will begin simultaneously. Building material, construction work, and other related activities will go on in parallel to provide cost savings to entity XY. This also helps AB achieve a timely completion of the two buildings and negotiate a consolidated price for the two buildings.

The above example suggests that there is a single contract negotiated to construct two buildings that are closely interrelated and interdependent in terms of their ultimate purpose and use. Therefore, this represents a Construction Contract.

Example 2

H, a sole-proprietor, contracts with M/s DM Construction, to dismantle his office premises and construct it from scratch.

In the given case, the construction contract includes both demolition as well as construction of a new building.

1.3 COMBINING AND SEGMENTING CONSTRUCTION CONTRACTS

A contractor may undertake a number of contracts.

The standard identifies certain cases where for the purposes of accounting, it is necessary to apply the Standard to the separately identifiable components of a single contract or to a group of contracts together in order to reflect the substance of a contract or a group of contracts.

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a. When a contract covers a number of assets, the construction of each asset should be treated as a separate construction contract when:

   i. separate proposals have been submitted for each asset;

   ii. each asset has been subject to separate negotiation and the contractor and customer have been able to accept or reject that part of the contract relating to each asset; and

   iii. the costs and revenues of each asset can be identified.

b. A group of contracts, whether with a single customer or with several customers, should be treated as a single construction contract when:

   i. the group of contracts is negotiated as a single package;

   ii. the contracts are so closely interrelated that they are, in effect, part of a single project with an overall profit margin; and

   iii. the contracts are performed concurrently or in a continuous sequence.

c. A contract may provide for the construction of an additional asset at the option of the customer or may be amended to include the construction of an additional asset. The construction of the additional asset should be treated as a separate construction contract when:

   i. the asset differs significantly in design, technology or function from the asset or assets covered by the original contract; or

   ii. the price of the asset is negotiated without regard to the original contract price.

(Refer Illustration 1)

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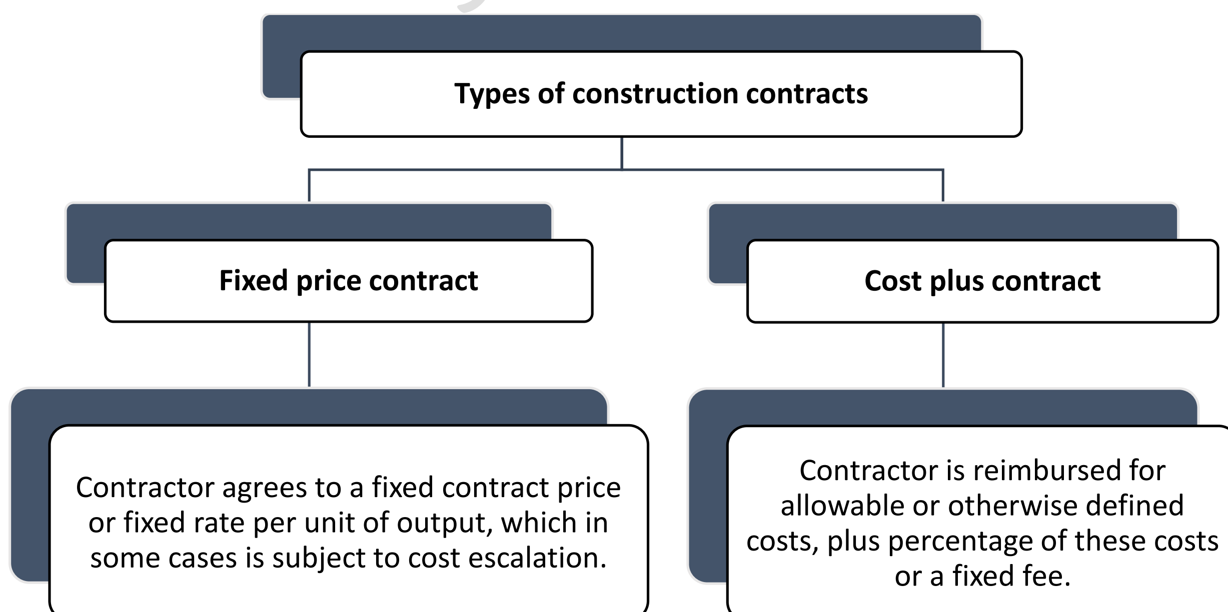
1.4 TYPES OF CONSTRUCTION CONTRACTS



In a **fixed price contract,** the price is agreed as fixed sum or a fixed rate per unit of output. In some cases, the contract may require the customer to pay additional sums to compensate the contractor against cost escalations.

Fixed price contracts are common in case of public tenders (construction of roads, flyovers, office buildings). Such constructions usually have a budgeted costs and the public entity does not intend to spend more than the tender amount. At the same time, there can be various reasons where the cost of construction may increase. For example, a sudden increase in wage rates, construction material costs, may require the contractor to add **cost-escalation clauses** and recover from the contractee. These cost escalations still meet the category of fixed price contracts.

A **cost-plus contract** is a construction contract in which the contractor is reimbursed for allowable or otherwise defined costs, plus percentage of these costs or a fixed fee.

Cost-plus contracts are common in case there is uncertainty of measurement of costs or time of completion. In such cases, a contractor does not expect to bear the loss due to those uncertainties. For example, if the scope of the contract cannot be fully assessed in the contract, both parties may agree to **cost-plus contracts**.

Under such contracts, the contractor is compensated for the costs incurred by him plus agreed profit-margin.

1.5 CONTRACT REVENUE AND COSTS

A. Contract revenue should comprise:

i. the initial amount of revenue agreed in the contract; and

ii. variations in contract work, claims and incentive payments to the extent that it is probable that they will result in revenue and they are capable of being reliably measured.

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Contract revenue includes:

Agreed price (fixed / Cost-plus price)

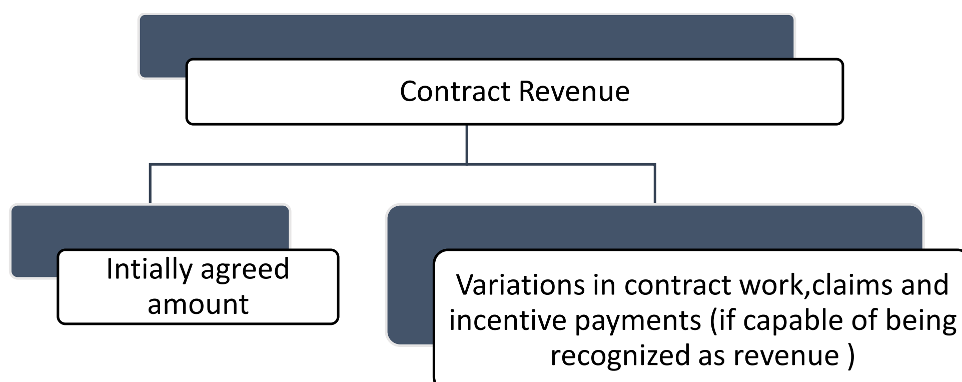
Plus: Agreed Cost escalation

Plus: * Claims (reimbursement for costs not included in the contract price)

Plus: **Incentive payments (usually for early completion)

Less: Penalties (usually for late completion)

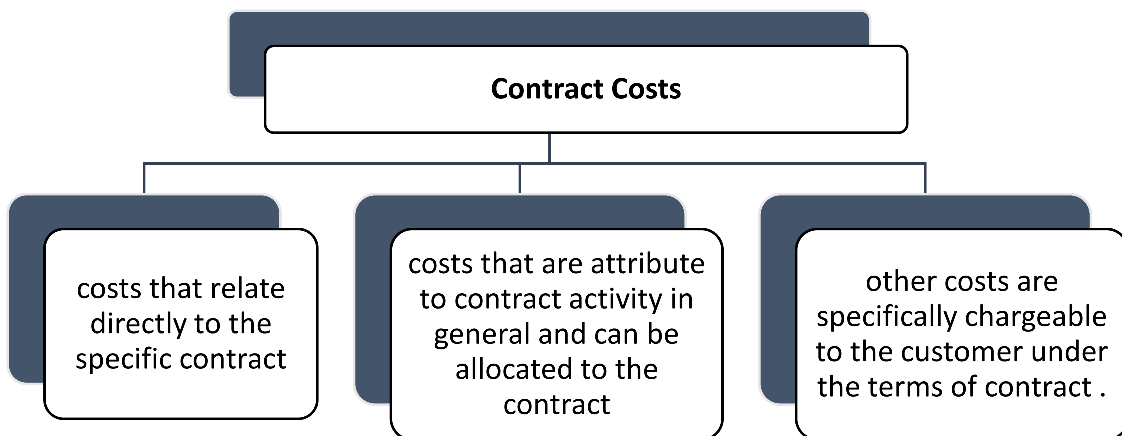
Adjusted for Variations



(Refer Illustration 2)

B. Contract costs should comprise:

- **i.** costs that relate directly to the specific contract;
- **ii.** costs that are attributable to contract activity in general and can be allocated to the contract; and
- **iii.** such other costs as are specifically chargeable to the customer under the terms of the contract.



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NOTE:

1. Examples of costs that relate directly to a specific contract include:

- **a.** site labour costs, including site supervision
- **b.** costs of materials used in construction
- **c.** depreciation of plant and equipment used on the contract
- **d.** costs of moving plant, equipment and materials to and from the contract site
- **e.** costs of hiring plant and equipment
- **f.** costs of design and technical assistance that is directly related to the contract
- **g.** the estimated costs of rectification and guarantee work, including expected warranty costs
- **h.** claims from third parties

Note: Direct costs can be reduced by incidental income that is not included in contract revenue, e.g., sale of surplus material and disposal of plant and equipment.

2. Example of costs that may be attributable to contract activity in general and can be allocated to specific contracts include:

- **a.** insurance
- **b.** costs of design and technical assistance that is not directly related to a specific contract
- **c.** construction overheads

The allocation of indirect costs should be based on normal levels of construction activity. The allocable costs may include borrowing costs as per AS 16.

3. Examples of costs that cannot be attributed to contract activity or cannot be allocated to a contract are excluded from the costs of a construction contract. Such costs include:
   a. general administration costs for which reimbursement is not specified in the contract
   b. selling costs
   c. research and development costs for which reimbursement is not specified in the contract
   d. depreciation of idle plant and equipment that is not used on a particular contract

Example 3: Cost-Plus contract

The language can be changed as under (Entire Question):

ABC Constructions has a contract to build an office building.

The terms and conditions are as under:

1. ABC's profit is agreed at:
   - 25% on expected contract's cost; For this purpose, the expected cost cannot exceed Rs.22 crores.
2. The agreed price will be revised depending upon the actual cost incurred.
   - The cost for fixation will be taken actual cost or Rs.22 crores whichever is less.

Price fixation based on expected cost:

Assume that the costs expected to be incurred by ABC are Rs.16 crore. Thus, ABC can charge a profit of Rs.4 crores (25% on actual cost).

The contract price will be Rs.20 crores. (Rs.16 crores plus Rs.4 crores)

Price fixation based on actual cost incurred – Scenario 1:

However, if cost incurred by ABC is Rs.15 crore, in that case, it would be able to charge a profit of:

= 25% on Rs.15 crore = 15 x 25% = Rs.3.75 crore

Thus, Total Value of the contract will stand revised as follows:

= Actual Costs + Profit (25% of costs) = Rs.15 crore + Rs.3.75 crore = Rs.18.75 crores.

Price fixation based on actual cost incurred – Scenario 2:

For any unavoidable reasons, if total cost incurred by ABC is Rs.25 crore, it can only charge a profit on the expected costs of Rs.22 crore as under:

Thus, Total Value of the contract will stand revised as follows:

= Expected Costs + Profit (20% of costs) = Rs.22 crore + Rs.4.40 crore = Rs.26.40 crores.

Analysis of the above scenario:

Cost actually incurred by ABC = Rs.25 crores.

Actual profit earned by ABC = Total Value of the contract – Actual costs incurred

= Rs.26.40 Crores – Rs.25 Crores = Rs.1.40 Crores.

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1.6 PERCENTAGE COMPLETION METHOD

As discussed in the beginning, Construction contracts are mostly long term, i.e., they take more than one accounting year to complete. This means, the final outcome (profit/ loss) of a construction contract can be determined only after a number of years from the year of commencement of construction are over. **It is nevertheless possible to recognise revenue annually in proportion of progress of work to be matched with corresponding construction costs incurred in that year.** This method of accounting, called the stage of completion method (percentage completion method), provides useful information on the extent of contract activity and performance during an accounting period.

The method is consistent with Accrual and Matching concepts of accounting.

AS 7 prescribe that the percentage completion method should not be used unless it is possible to make a reasonable estimate of the final outcome of the contract.

In reality, the actual profit or loss that is expected to be earned in such contracts is not possible. Therefore, companies make use of different estimates to arrive at the possible costs they are likely to incur for the construction. Large infrastructure companies, builders expect to carry the required industry-experience. On that basis, the pricing quoted by these companies for tenders take care of all possible costs and expected profit. Therefore, in substance, <u>a reasonable estimate</u> of the final outcome is possible in many such cases.

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As per AS 7, the outcome of fixed price contracts can be estimated reliably when all the following conditions are satisfied:

i. <u>total contract revenue can be measured reliably</u>;

ii. it is probable that the economic benefits associated with the contract will flow to the enterprise;

iii. both the contract costs to complete the contract and the stage of contract completion at the reporting date can be measured reliably; and

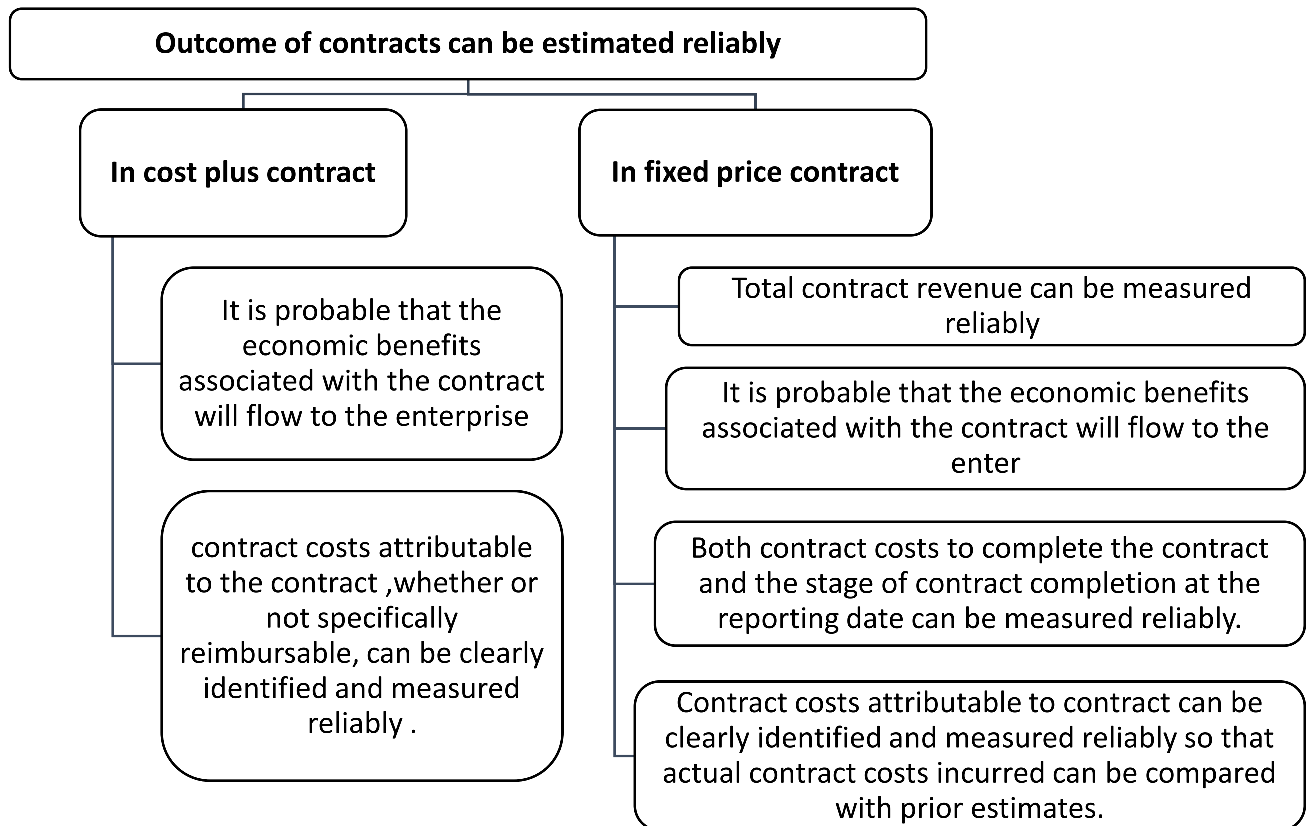
iv. the contract costs attributable to the contract can be clearly identified and measured reliably so that actual contract costs incurred can be compared with prior estimates.

The outcome of a cost-plus contract can be estimated reliably when all the following conditions are satisfied:

i. it is probable that the <u>economic benefits</u> associated with the contract <u>will flow to the enterprise; and</u>

ii. the contract costs attributable to the contract, whether or not specifically reimbursable, can be clearly identified and measured reliably.

Flowchart depicting the conditions under which the outcome of a construction contract can be reliably estimated:



Also, AS 7 provides that whenever total contract cost is expected to exceed the total contract revenue, the loss should be recognised as an expense immediately.

We may argue that why would an entity enter into a loss-making contract. It can happen that after having entered into the construction contract, there is a sudden rise in the costs which was not expected, nor are these covered under the **cost escalation clause**. Another reason, is that, an entity may enter into a loss-making contract is to penetrate the market. Therefore, it is not uncommon for companies to sometimes enter into loss-making contracts.

Under the prudence concept, we must always make a provision for all expected losses.

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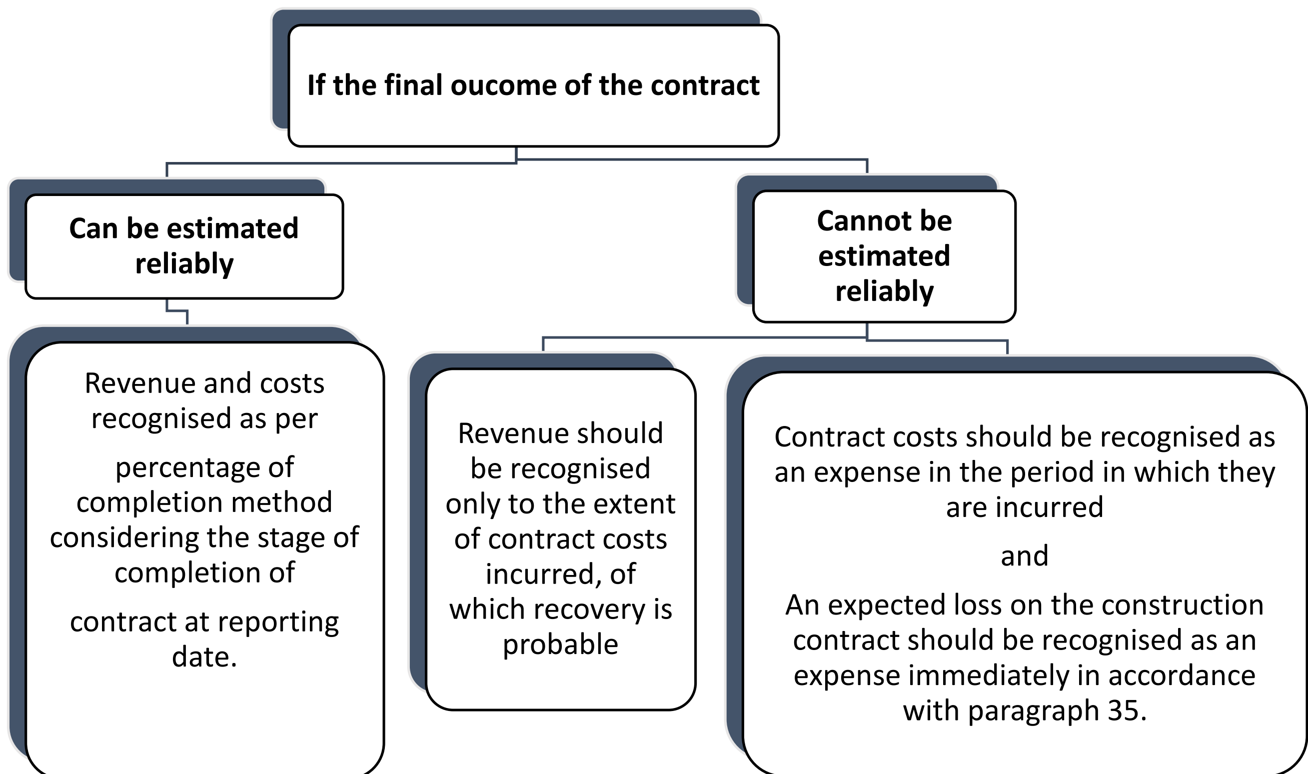

(Refer Illustration 3 & 4)

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Example 4

X Ltd. commenced a construction contract on 01/04/X1. The contract price agreed was reimbursable cost plus 10%. The company incurred Rs.1,00,000 in 20X1-X2, of which cost of Rs.90,000 is reimbursable. The further non-reimbursable costs to be incurred to complete the contract are estimated at Rs.5,000. The other costs to complete the contract could not be estimated reliably. The Profit & Loss A/c extract of X Ltd. for 20X1-X2 is shown below:

<u>Solution</u>

Profit & Loss Account

	Rs. 000		**Rs. 000**
To Construction Costs	100	By Contract Price (90+9)	99
To Provision for loss	5	Net loss	6
	105		105

1.7 TREATMENT OF COSTS RELATING TO FUTURE ACTIVITY

Under the percentage of completion method, **<u>contract revenue is recognised as revenue in the statement of profit and loss in the accounting periods in which the work is performed</u>**. Contract costs are usually recognised as an expense in the statement of profit and loss in the accounting periods in which the work to which they relate is performed. The contract costs that relate to future activity on the contract are however recognised as an asset provided it is probable that they will be

recovered. **<u>Such costs represent an amount due from the customer and are often classified as contract work in progress.</u>**

1.8 UNCOLLECTABLE CONTRACT REVENUE

When an uncertainty arises about the collectability of an amount already included in contract revenue, and already recognised in the statement of profit and loss, the uncollectable amount or the amount in respect of which recovery has ceased to be probable is recognised as an expense rather than as an adjustment of the amount of contract revenue.

1.9 STAGE OF COMPLETION

The stage of completion of a contract may be determined in a variety of ways. The enterprise uses the method that measures reliably the work performed. Depending on the nature of the contract, the methods may include:

a. the proportion that contract costs incurred for work performed up to the reporting date bear to the estimated total contract costs; or

b. surveys of work performed; or

c. completion of a physical proportion of the contract work.

Progress payments and advances received from customers may not necessarily reflect the work performed.

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Calculation of Stage of completion under proportion of costs incurred method.

This method may be useful in case of contracts where cost is closely monitored by the contractor. This method could be more commonly used in case of private contracts to construct office buildings, machinery or equipment

$$= \frac{\text{Actual cost incurred}}{\text{Estimated total cost} \times 100}$$

$$= \frac{\text{Actual cost incurred}}{\text{Actual cost incurred} + \text{Estimated future cost} \times 100}$$

Calculation of Stage of completion under Surveyor of work performed method

Generally, in case of government projects, a surveyor is appointed to oversee various parameters like quality of work, material used, etc. Based on these parameters, the surveyor would assess the percentage of work completed. The certification done by the appointed surveyor is used as the percentage of work completed.

Calculation of Stage of completion of a physical proportion of the contract work method

This method is commonly used in case of construction work which is not very complicated. For example, a contract to place tiles can be regarded as complete on the basis of area covered as a proportion of total area expected to be covered. Thus, for example If the area to be covered is 1,000 sq. ft., and the total area already covered is 300 sq. ft., this implies that 30% of the work is completed.

(Refer Illustration 5)

1.10 CHANGES IN ESTIMATES

The percentage of completion method is applied on a cumulative basis in each accounting period to the current estimates of contract revenue and contract costs. Therefore, the effect of a change in the estimate of contract revenue or contract costs, or the effect of a change in the estimate of the outcome of a contract, is accounted for as a change in accounting estimate in accordance with AS 5. The changed estimates are used in determination of the amount of revenue and expenses recognised in the statement of profit and loss in the period in which the change is made and in subsequent periods.

1.11 DISCLOSURE

a. An enterprise should disclose:

- **i.** the amount of contract revenue recognised as revenue in the period;
- **ii.** the methods used to determine the contract revenue recognised in the period; and
- **iii.** the methods used to determine the stage of completion of contracts in progress.

b. An enterprise should disclose following in respect of contracts in progress at the reporting date:

- **i.** the aggregate amount of costs incurred and recognised profits (less recognised losses) up to the reporting date;
- **ii.** the amount of advances received; and
- **iii.** the amount of retentions.
  - **Retentions** are amounts of progress billings which are not paid until the satisfaction of conditions specified in the contract for the payment of such amounts or until defects have been rectified.
  - **Progress billings** are amounts billed for work performed on a contract whether or not they have been paid by the customer.
  - **Advances** are amounts received by the contractor before the related work is performed.

c. An enterprise should present:

- **i.** the gross amount due from customers for contract work as an asset; and

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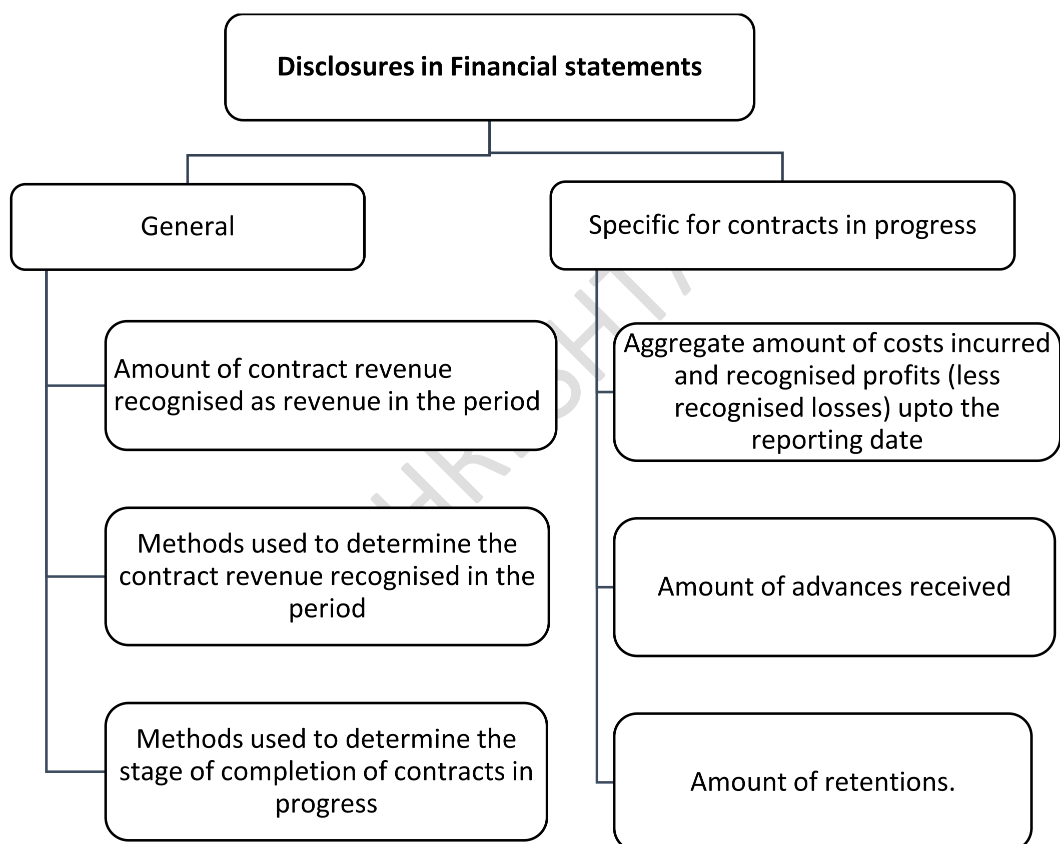
ii. the gross amount due to customers for contract work as a liability.

Particulars	Rs.
Costs incurred	xxx
Plus: Recognised profits	xxx
Less: Recognised losses	xxx
Less: Progress billings	xxx
Amount	xxx
If above amount is **positive**- Gross amount due from customers	
If above amount is **negative**- Gross amount due to customers	



(Refer Illustration 6 & 7)

ILLUSTRATIONS

Illustration 1

XYZ construction Ltd, a construction company undertakes the construction of an industrial complex. It has separate proposals raised for each unit to be constructed in the industrial complex. Since each unit is subject to separate negotiation, he is able to identify the costs and revenues attributable to each unit. Should XYZ Ltd, treat construction of each unit as a separate construction contract according to AS 7?

Solution

As per AS 7 'Construction Contracts', when a contract covers a number of assets, the construction of each asset should be treated as a separate construction contract when:

a. separate proposals have been submitted for each asset;

b. each asset has been subject to separate negotiation and the contractor and customer have been able to accept or reject that part of the contract relating to each asset; and

c. the costs and revenues of each asset can be identified.

Therefore, XYZ Ltd. is required to treat construction of each unit as a separate construction contract.

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Illustration 2

AB contactors enter into a contract on 1st January 20X1 with XY to construct a 5- storied building. Under the contract, AB is required to complete the construction in 3 years (i.e., by 31st December 20X3). The following information is relevant:

Fixed price (agreed) Rs.5 crore

Material cost escalation (to the extent of 20% of increase in material cost)

Labour cost escalation (up to 30% of increase in minimum wages)

In case AB is able to complete the construction in less than 2 years and 10 months, it will be entitled for an additional incentive of Rs.50 lakh. However, in case the construction is delayed beyond 3 years and 2 months, XY will charge a penalty of Rs.20 lakh. At the start of the contract, AB has a reason to believe that construction will be completed in 2 years and 8 months. Assume that the construction was actually completed in 2 years 9 months.

Labour cost was originally estimated to be Rs.1.20 crore (based on initial minimum wages). However, the costs have increased by 25% during the construction period.

Material costs have increased by 40% due to short-supply. The total increase in material cost due to the 40% escalation is Rs.80 lakh.

You are required to suggest what should be the contract revenue in above case?

Assume that in year 20X2, XY has requested AB to increase the scope of the contract. An additional floor is required to be constructed and there is an increase in contract fee by Rs.1 crore. AB has incurred a cost of Rs.20 lakh for getting the local authority approvals which it will be entitled to claim from XY in addition to the increase in the fixed fee.

Also measure the total contract revenue in this case.

Solution

Total Revenue after considering the escalation costs, claims and incentives:

	Rs.
Fixed Price:	5.00 crore
Incentive for early completion	0.50 crore
Material costs recovery (to the extent of 20%)	0.40 crore
Labour costs recovery (Actual increase is less than 30%) [1.20 crore x 25%]	0.30 crore
Total Contract Revenue	6.20 crore
Add: Variation to the contract	1.00 crore
Add: Claims recoverable from XY	0.20 crore
Total Contract Revenue	7.40 crore

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Illustration 3 (Percentage completion method)

X Ltd. commenced a construction contract on 01-04-20X1. The fixed contract price agreed was Rs.2,00,000. The company incurred Rs.81,000 in 20X1-X2 for 45% work and received Rs.79,000 as progress payment from the customer. The cost incurred in 20X2-X3 was Rs.89,000 to complete the rest of work. Show the extract of the Profit and Loss Account and Customer's Account for the related years.

Solution

Profit & Loss Account

Year		Rs. 000	Year		Rs. 000
20X1-X2	To Construction Costs (for 45% work)	81	20X1-X2	By Contract Price (45% of Contract Price)	90
	To Net profit (for 45% work)	9			
		90			90

20X2-X3	To Construction costs (for 55% work) To Net Profit (for 55% work)	89 21	20X2-X3	By Contract Price (55% of Contract Price)	110
		110			110

Customer's Account

Year		Rs. 000	Year		Rs. 000
20X1-X2	To Contract Price	90	20X1-X2	By Bank	79
				By Balance c/d	11
		90			90
20X2-X3	To Balance b/d	11	20X2-X3	By Bank	121
	To Contract Price	110			
		121			121

AS 7 provides that the percentage completion method should not be applied if the outcome of a construction contract cannot be estimated reliably. In such cases:

a. revenue should be recognised only to the extent of contract costs incurred of which recovery is probable; and

b. contract costs should be recognised as an expense in the period in which they are incurred.

An expected loss on the construction contract should be recognised as an expense immediately in accordance with paragraph 35.

Illustration 4

PQ & Associates undertakes a construction contract the details of which are provided below:

Total Contract Value	**Rs.40 lakh**
Costs incurred to date	**Rs.3 lakh**
Estimated future costs of completion	**Rs.30 lakh**
Work completed	**10%**

The work has started some time ago and there is an uncertainty with respect to the outcome of the contract due to expected changes in regulations. PQ is certain that it would be able to recover the costs incurred to date.

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Solution

In the given case, revenue and costs can only be recognised to the extent of the costs incurred and those which are expected to be recovered. Therefore, the profit & loss statement would appear as under:

Contract Revenue	Rs.3 lakh
Contract Costs	Rs.3 lakh
Contract Profit	Nil

When the uncertainties that prevented the outcome of the contract being estimated reliably cease to exist, revenue and expenses associated with the construction contract should be recognised by the percentage completion method.

Illustration 5 (Stage of completion for a loss-making contract)

Show Profit & Loss A/c (Extract) in books of a contractor in respect of the following data for Year 1.

Information for Year 1	Rs. 000
Contract price (Fixed)	**600**
Cost incurred to date	**390**
Estimated cost to complete	**260**

Assume that the contract period is 2 years. The contract is 100% completed by Year 2. Actual costs incurred is the same as total estimated costs to complete (Cost incurred to date plus estimated cost to complete).

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Solution

		Amount INR Rs. 000	
	Year (1)	**Total up to Year2 (2)**	**Year 2 (2) – (1)**
A. Cost incurred to date	(390)	(650)	(260)
B. Estimate of cost to completion	(260)	-	-
C. Estimated total cost	(650)	650	650
D. Degree of completion (A/C)	60%	100%	40%
E. Revenue Recognised			
(60% of 600)	360		
(100% of 600)		600	240
Total foreseeable loss (650 – 600)	50		
Less: Loss for current year (E – A)	(30)		
Expected loss to be recognised immediately	(20)		
Reversal of Loss provision in Year 2			20

Profit & Loss A/c (Year 1)

	Rs.		Rs.
To Construction costs	390	By Contract Price	360
To Provision for loss	20	By Net Loss	50
	410		410

Profit & Loss A/c (Year 2)

	Rs.		Rs.
To Construction costs	260	By Contract Price	240
		By Reversal of Provision for loss	20
	260		260

Illustration 6

A firm of contractors obtained a contract for construction of bridges across river Revathi. The following details are available in the records kept for the year ended 31st March, 20X1.

	(Rs. in lakhs)
Total Contract Price	1,000
Work Certified for the cost incurred	500
Work yet not Certified for the cost incurred	105
Estimated further Cost to Completion	495
Progress Payment Received	400
To be Received	140

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The firm seeks your advice and assistance in the presentation of accounts keeping in view the requirements of AS 7 issued by your institute.

Solution

a.		(Rs. in lakhs)
	Amount of foreseeable loss:	
	Total cost of construction (500 + 105 + 495)	1,100
	Less: Total contract price	(1,000)
	Total foreseeable loss to be recognized as expense	100

According AS 7, when it is probable that total contract costs will exceed total contract revenue, the expected loss should be recognized as an expense immediately.

b.		(Rs. in lakhs)
	Contract work-in-progress i.e. cost incurred to date are Rs.605 lakhs	
	Work certified	500

	Work not certified	105
		605
This is 55% (605/1,100 × 100) of total costs of construction.		

a. Proportion of total contract value recognized as revenue:

55% of Rs. 1,000 lakhs = Rs. 550 lakhs

b. Gross Amount due from/to customers = (Contract costs + Recognized profits – Recognized Losses) – (Progress payments received + Progress payments to be received)

= (605 + Nil – 100) – (400 + 140) Rs. in lakhs

= [505 – 540] Rs. in lakhs

Amount due to customers = Rs. 35 lakhs

The amount of Rs. 35 lakhs will be shown in the balance sheet as liability.

c. The relevant disclosures under AS 7 are given below:

	Rs. in lakhs
Contract revenue	550
Contract expenses	605
Recognised profits less recognised losses	(100)
Progress billings Rs. (400 + 140)	540
Retentions (billed but not received from contractee)	140
Gross amount due to customers	35
Method of revenue recognition (use of percentage completion method)	
Method of determining state of completion (based on proportionate cost)	

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Illustration 7

On 1st December, 20X1, Vishwakarma Construction Co. Ltd. undertook a contract to construct a building for Rs. 85 lakhs. On 31st March, 20X2, the company found that it had already spent Rs. 64,99,000 on the construction. Prudent estimate of additional cost for completion was Rs. 32,01,000. What amount should be recognized in the statement of profit and loss for the year ended 31st March, 20X2 as per provisions of Accounting Standard 7 (Revised)?

Solution

	Rs.
Cost incurred till 31st March, 20X2	64,99,000
Prudent estimate of additional cost for completion	32,01,000
Total cost of construction	97,00,000

Less: Contract price	(85,00,000)
Total foreseeable loss	12,00,000

According to AS 7, the amount of Rs. 12,00,000 is required to be recognised as an expense.

Contract work in progress $= \frac{Rs.64,99,000 \times 100}{97,00,000} = 67\%$

Proportion of total contract value recognised as turnover:

= 67% of Rs. 85,00,000 = Rs. 56,95,000.

The amount of expected loss will be split as under:

Particulars	Workings	Amount
Expected Loss]	97,00,000 – 85,00,000	12,00,000
Contract revenue	67% of 85,00,000	56,95,000
Contract cost	Given	64,99,000
Actual loss	56,95,000 – 64,99,000	8,04,000
Amount of provision required [As per Para 35]	12,00,000 – 8,04,000	3,96,000

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TEST YOUR KNOWLEDGE

MCQs

The below information relates to Questions 1 – 3:

XY Ltd. agrees to construct a building on behalf of its client GH Ltd. on 1st April 20X1. The expected completion time is 3 years. XY Ltd. incurred a cost of Rs.30 lakh up to 31st March 20X2. It is expected that additional costs of Rs.90 lakh. Total contract value is Rs.112 lakh. As at 31st March 20X2, XY Ltd. has billed GH Ltd. for Rs.42 lakh as per the agreement. Assume that the work is completed to the extent of 75% by the end of Year 2.

1. Revenue to be recognized by XY Ltd. for the year ended 31st March 20X2 is

- **a. Rs. 28 lakh**
- **b. Rs. 42 lakh**
- **c. Rs. 30 lakh**
- **d. Rs. 32 lakh**

2. Total expense to be recognised in Year 1 is

- **a. Rs. 30 lakh**
- **b. Rs. 120 lakh**
- **c. Rs. 38 lakh**
- **d. Rs. 36 lakh**

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3. Revenue to be recognised for year 2 is

- **a. Rs. 84 lakh**
- **b. Rs. 42 lakh**
- **c. Rs. 56 lakh**
- **d. Rs. 28 lakh**

Below information relates to Questions 4 – 5

M/s AV has presented the information for Contract No. XY123:

Total contract value Rs. 370 lakh

Certified work completed Rs. 320 lakh

Costs incurred to date Rs. 360 lakh

Progress Payments received Rs. 300 lakh

Expected future costs to be incurred Rs. 50 lakh

4. **Revenue to be recognised by M/s AV is**
   a. **Rs. 320 lakh**
   b. **Rs. 370 lakh**
   c. **Rs. 360 lakh**
   d. **Rs. 400 lakh**

5. **Total expense to be recognised by M/s AV is**
   a. **Rs. 360 lakh**
   b. **Rs. 400 lakh**
   c. **Rs. 320 lakh**
   d. **Rs. 360 lakh**

6. **LP Contractors undertakes a fixed price contract of Rs. 200 lakh. Transactions related to the contract include:**

   Material purchased: Rs. 80 lakh

   Unused material: Rs. 30 lakh

   Labour charges: Rs. 60 lakh

   Machine used for 3 years for the contract. Original cost of the machine is Rs. 100 lakh. Expected useful life is 15 years.

   Estimated future costs to be incurred to complete the contract: Rs. 80 lakh.

   Loss on contract to be recognised is:
   a. **Rs. 40 lakh**
   b. **Rs. 10 lakh**
   c. **Rs. 90 lakh**
   d. **Rs. 50 lakh**

ANSWERS/SOLUTIONS

MCQ

1.	**a.**	Rs. 28 lakh
2.	**d.**	Rs. 36 lakh
3.	**c.**	Rs. 56 lakh
4.	**a.**	Rs. 320 lakh
5.	**d.**	Rs. 360 lakh
6.	**b.**	Rs. 10 lakh

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THEORY QUESTIONS

Q.NO.1. It is argued that profit on construction contracts should not be recognised until the contract is completed. Please explain whether you believe that this suggestion would improve the quality of financial reporting for long-term construction contracts.

ANSWER

Usually, construction contracts are long term nature i.e., the contracts are entered in one accounting period, however, the work performed will flow into more than one accounting year. If the profit on construction contracts is not recognised over the construction period, then the costs incurred during the earlier years of the contract would be recognised without any corresponding revenue. This will result in losses for initial years followed high profits in future years.

The current treatment under AS 7 results in matching of revenue and associated costs as they are recognised during the same period. Also, the current accounting incorporates the prudence concept as any foreseeable losses are accounted for immediately.

Therefore, AS 7 results in a fair representation of the underlying financial substance of the transaction.

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Q.NO.2. A contractor has entered into a contract with a municipal body for construction of a flyover. As per the contract terms, the contractor will receive an additional Rs. 2 Crore as incentive if the construction of the flyover were to be finished within a period of two years from the start of the contract. The contractor wants to recognize this revenue since in the past he has been able to meet similar targets very easily.

Explain whether the contractor's view-point is correct?

ANSWER

The contractor's view is not entirely correct in considering the variation as a part of contract revenue. There is an argument that he has been able to complete similar contracts within stipulated time. However, each contract needs to be assessed in isolation with respect to the specific challenges associated with the timing and uncertainty in completion.

Accordingly, the contractor needs to validate the assumptions with respect to the specific contract. Only after that assessment is done, the incentive of Rs. 2 crore may be included within the contract revenue.

PRACTICAL QUESTIONS

Q.NO.1. A construction contractor has a fixed price contract for Rs. 9,000 lakhs to build a bridge in 3 years time frame. A summary of some of the financial data is as under:

	(Amount Rs. in lakhs)		
	Year 1	**Year 2**	**Year 3**
Initial Amount for revenue agreed in contract	**9,000**	**9,000**	**9,000**
Variation in Revenue (+)	**-**	**200**	**200**
Contracts costs incurred up to the reporting date	**2,093**	**6,168***	**8,100****
Estimated profit for whole contract	**950**	**1,000**	**1,000**

***Includes Rs. 100 lakhs for standard materials stored at the site to be used in year 3 to complete the work.**

****Excludes Rs. 100 lakhs for standard material brought forward from year 2. The variation in cost and revenue in year 2 has been approved by customer.**

Compute year wise amount of revenue, expenses, contract cost to complete and profit or loss to be recognized in the Statement of Profit and Loss as per AS-7 (revised).

SOLUTION

The amounts of revenue, expenses and profit recognized in the statement of profit and loss in three years are computed below:

(Amount in Rs. lakhs)

	Up to the reporting date	**Recognized in previous years**	**Recognized in current year**
Year 1			
Revenue (9,000 x 26%)	2,340	-	2,340
Expenses (8,050 x 26%)	2,093	-	2,093
Profit	247	-	247
Year 2			
Revenue (9,200 x 74%)	6,808	2,340	4,468
Expenses (8,200 x 74%)	6,068	2,093	3,975
Profit	740	247	493
Year 3			
Revenue (9,200 x 100%)	9,200	6,808	2,132
Expenses (8,200 x 100%)	8,200	6,068	2,392
Profit	1,000	740	260

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Working Note:

	Year 1	Year 2	Year 3
Revenue after considering variations	9,000	9,200	9,200
Less: Estimated profit for whole contract	950	1,000	1,000
Estimated total cost of the contract (A)	8,050	8,200	8,200
Actual cost incurred upto the reporting date (B)	2,093	6,068	8,200
		(6,168-100)	(8,100+100)
Degree of completion (B/A)	26%	74%	100%

Q.NO.2. Akar Ltd. Signed on 01/04/X1, a construction contract for Rs. 1,50,00,000. Following particulars are extracted in respect of contract, for the year ended 31/03/X2.

- **Materials used Rs. 71,00,000**
- **Labour charges paid Rs. 36,00,000**
- **Hire charges of plant Rs. 10,00,000**
- **Other contract cost incurred Rs. 15,00,000**
- **Labour charges of Rs. 2,00,000 are still outstanding on 31.3.X2.**
- **It is estimated that by spending further Rs. 33,50,000 the work can be completed in all respect.**

You are required to compute profit/loss for the year to be taken to Profit & Loss Account and any provision for foreseeable loss to be recognized as per AS 7.

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SOLUTION

Statement showing the amount of profit/loss to be taken to Profit and Loss Account and additional provision for the foreseeable loss as per AS 7

Cost of Construction	**Rs.**	**Rs.**
Material used		71,00,000
Labour Charges paid	36,00,000	
Add: Outstanding on 31.03.20X2	2,00,000	38,00,000
Hire Charges of Plant		10,00,000
Other Contract cost incurred		15,00,000
Cost incurred up to 31.03.20X2		1,34,00,000
Add: Estimated future cost		33,50,000
Total Estimated cost of construction		1,67,50,000

Degree of completion (1,34,00,000/1,67,50,000 x 100)	80%
Revenue recognized (80% of 1,50,00,000)	1,20,00,000
Total foreseeable loss (1,67,50,000 - 1,50,00,000)	17,50,000
Less: Loss for the current year (1,34,00,000 - 1,20,00,000)	14,00,000
Loss to be provided for	3,50,000

Q.NO.3. RT Enterprises has entered into a fixed price contract for construction of a tower with its customer. Initial tender price agreed is Rs. 220 crore. At the start of the contract, it is estimated that total costs to be incurred will be Rs. 200 crore. At the end of year 1, this estimate stands revised to Rs. 202 crore. Assume that the construction is expected to be completed in 3 years. During year 2, the customer has requested for a variation in the contract. As a result of that, the total contract value will increase by Rs. 5 crore and the costs will increase by Rs. 3 crore.

RT has decided to measure the stage of completion on the basis of the proportion of contract costs incurred to the total estimated contract costs. Contract costs incurred at the end of each year is:

Year 1: Rs. 52.52 crore

Year 2: Rs. 154.20 crore (including unused material of 2.5 crore)

SOLUTION

a. Stage of completion = Costs incurred to date / Total estimated costs

Year 1: 52.52 crore / 202 crore = 26%

Year 2: (154.20 crore – 2.50 crore) / 205 crore = 74%

Year 3: 205 crore / 205 crore = 100%

b. Profit for the year

	Year 1	**Year 2**	**Year 3**
Contract Revenue (1)	57.20 crore	109.30 crore	58.50 crore
	(220 crore x 26%)	(225 crore x 74% - 57.20 crore)	(225 crore x 100% - 109.30 crore – 57.20 crore)
Contract Cost (2)	52.52 crore	99.18 crore	53.30 crore
	(202 crore x 26%)	(205 crore x 74% - 52.52 crore)	(205 crore x 100% - 99.18 crore – 52.52 crore)
Contract Profit (1) – (2)	4.68 crore	10.12 crore	5.20 crore

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UNIT 2: ACCOUNTING STANDARD 9 REVENUE RECOGNITION

LEARNING OUTCOMES

After studying this unit, you will be able to comprehend the provisions of AS 9 related with–

- Recognition of revenue in case of:
    - Sale of Goods
    - Rendering of Services
    - The Use by Others of Enterprise Resources Yielding Interest,Royalties and Dividends
- Effect of Uncertainties on Revenue Recognition
- Required Disclosures.

2.1 INTRODUCTION

Revenue (also called as Top Line), or Sales is the backbone for any business. A higher revenue would normally reflect an increase in market share, higher prospects, and eventually an increased value of the business. You would notice that many start-up entities are more focused to increase their market penetration and revenue without initially focusing on the profitability.

As a result, it is critical to have a standard that addresses how entities must recognised the revenue, with respect to the amount and timing in a particular accounting period.

AS 9 deals with the bases for recognition of revenue in the statement of profit and loss of an enterprise. **AS 9 is mandatory for all enterprises.** The Standard is concerned with the recognition of revenue arising in the course of the ordinary activities of the enterprise from

- the sale of goods
- the rendering of services
- the use by others of enterprise resources yielding interest, royalties and dividends

AS 9 does not deal with the following aspects of revenue recognition to which special considerations apply:

i. Revenue arising from construction contracts;

ii. Revenue arising from hire-purchase, lease agreements;

iii. Revenue arising from government grants and other similar subsidies;

iv. Revenue of insurance companies arising from insurance contracts.

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Examples of items not included within the definition of "revenue" for the purpose of AS 9 are:

i. Realized gains resulting from the disposal of, and unrealized gains resulting from the holding of, non-current assets, e.g., appreciation in the value of fixed assets;

ii. Unrealized holding gains resulting from the change in value of current assets, and the natural increases in herds and agricultural and forest products;

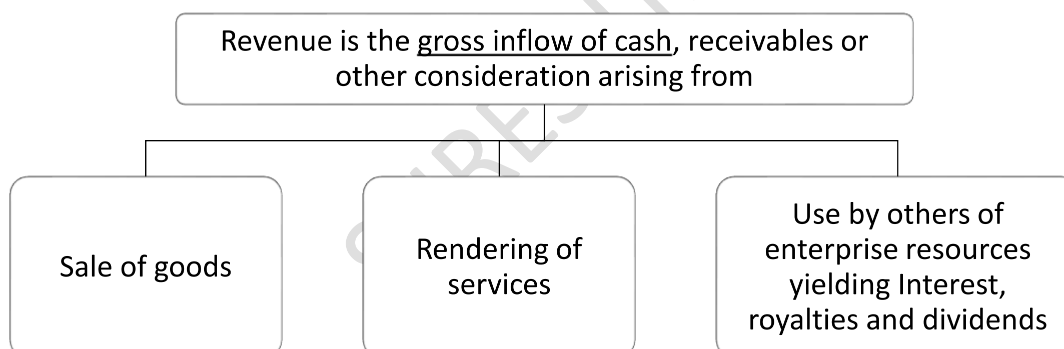
iii. Realized or unrealized gains resulting from changes in foreign exchange rates and adjustments arising on the translation of foreign currency financial statements;

iv. Realized gains resulting from the discharge of an obligation at less than its carrying amount;

v. Unrealized gains resulting from the restatement of the carrying amount ofan obligation.

2.2 DEFINITION OF REVENUE

Revenue is the gross inflow of cash, receivables or other consideration arising inthe course of the ordinary activities of an enterprise from the sale of goods, from the rendering of services, and from the use by others of enterprise resources yielding interest, royalties and dividends.



Example 1

Entity XY sells a machine being used at its factory at a price of Rs.2 lakh. The carrying value of the machine is Rs.1.80 lakh. The sale of the machine does not increase the revenue of XY but is an example of a capital receipt since transaction does not take place in the normal course of business. Such gain on sale of

Rs.20,000 (Rs.2 lakhs – Rs.1.80 lakhs) is recognised as a part of profit & loss statement under Gain/(Loss) on disposal of asset.

Example 2

ST Ltd is a real-estate developer and builder. It is into the business of buying andselling properties. In 20X1, ST Ltd purchased a unit of land for Rs.150 crore. It sold off that land after few months at a price of Rs.240 crore.

In the above case, the sale of land is a transaction that happens in the ordinary course of business (as he is a real estate developer and builder – properties will bean item of inventory in the financial statements) for ST Ltd. Hence, it should recognise a revenue of Rs.240 crore when the land is sold.

Example 3

DL Ltd, a pharma company, has been conducting research on new medicine since last 2 years to increase the immunity levels of the people consuming it without any side effects. During the current year, it decides to sell the outcome of the research undertaken so far to another competitor, GH Ltd for Rs.50 crore. DL has already incurred Rs.30 crore on the ongoing research.

In the above example, the sale of the research findings does not represent an increase in revenue. This is because DL Ltd's business is not to sell these research findings in the ordinary course of business. The amount of Rs.50 crore will be a part of Other Income in the profit & loss statement.

2.3 AGENCY RELATIONSHIP

In an agency relationship, the revenue is the amount of commission and not the gross inflow of cash, receivables or other consideration.

The criteria of principal-agency relationship is significant to understand how much revenue can be recognised by an entity for a sale transaction. The key principle is whether the sale transaction is made by an entity on its own, or on behalf of someone else. Whether the risks and rewards pertaining to the goods or services are with the entity or with someone else, would determine the seller's capacity as principal or agency (agent).

When another party is involved in providing goods or services to a customer, the entity shall determine whether it has an obligation to sell or provide the specified goods or services itself (i.e., the entity is a principal) or to arrange for those goods or services to be sold or provided by the other party (i.e., the entity is an agent).

(Refer Illustration 1)

Example 4

Trip Deal is a website that allows people to book airlines tickets. As a part of the business, it agrees to buys 100 tickets from an airline on a particular date and resells those tickets to customers. However, Trip Deal bears the loss for any unsold tickets.

In the above example, the risks and rewards relating to tickets are borne by Trip Deal. Hence, sales made for the tickets will be fully recognized as part of its revenue. Any unsold tickets will be charged as loss by the entity.

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2.4 SALE OF GOODS

Revenue from sales transactions should be recognised when the requirements asto performance set out in below in para 2.5 'Timing of Recognition of Revenue from Sale of Goods' are satisfied, provided that at the time of performance it is not unreasonable to expect ultimate collection. If at the time of raising of any claim it is unreasonable to expect ultimate collection, revenue recognition should be postponed.

(Refer Illustration 2)

2.5 TIMING OF RECOGNITION OF REVENUE FROM SALE OF GOODS

In a transaction involving the sale of goods, performance should be regarded as being achieved when the following conditions have been fulfilled:

i. the seller of goods has transferred to the buyer the property in the goods for a price or

ii. all significant risks and rewards of ownership have been transferred to the buyer and the seller retains no effective control of the goods transferred toa degree usually associated with ownership; and

iii. no significant uncertainty exists regarding the amount of the considerationthat will be derived from the sale of the goods.

Note:

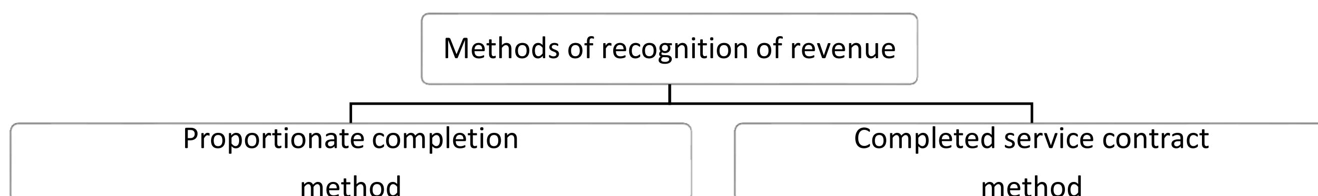
The transfer of property in goods, in most cases, results in or coincides with the transfer of significant risks and rewards of ownership to the buyer. However, there may be situations where transfer of property in goods does not coincide with the transfer of significant risks and rewards of ownership. Revenue in such situations is recognised at the time of transfer of significant risks and rewards of ownership to the buyer.

Such cases may arise where delivery has been delayed through the fault of either the buyer or the seller and the goods are at the risk of the party at fault as regards any loss which might not have occurred but for such fault. Further, sometimes the parties may agree that the risk will pass at a time different from the time when ownership passes

(Refer Illustration 3)

2.6 RENDERING OF SERVICES

Revenue from service transactions is usually recognised as the service is performed. There are two methods of recognition of revenue from service transaction, viz,



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Proportionate Completion Method is a method of accounting which recognises revenue in the statement of profit and loss proportionately with the degree of completion of services under a contract. Here performance consists of the execution of more than one act. Revenue is recognised proportionately by reference to the performance of each act.

Completed Service Contract Method is a method of accounting which recognises revenue in the statement of profit and loss only when the rendering of services under a contract is completed or substantially completed. In this method performance consists of the execution of a single act e.g., installation of a machine, or repair service,

Alternatively, services are performed in more than a single act, and the services yet to be performed are so significant in relation to the transaction taken that performance cannot be deemed to have been completed until the execution of those acts.

The completed service contract method is relevant to these patterns of performance and accordingly revenue is recognised when the sole or final act takes place and the service becomes chargeable.

Revenue from sales or service transactions should be recognised when the service is performed provided that at the time of performance it is not unreasonable to expect ultimate collection. If at the time of raising of any claim it is unreasonableto expect ultimate collection, revenue recognition should be postponed.

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2.7 INCOME FROM OTHER SOURCES - INTEREST, ROYALTIES AND DIVIDENDS

Use by others of such enterprise resources gives rise to:

i. **Interest**: charges for the use of cash resources or amounts due to the enterprise. Revenue is recognized on a time proportion basis taking into account the amount outstanding and the rate applicable.
ii. **Royalties**: charges for the use of such assets as know-how, patents, trade marks and copyrights. Revenue is recognized on an accrual basis in accordance with the terms of the relevant agreement.
iii. **Dividends**: rewards from the holding of investments in shares. Revenue is recognized when the owner's right to receive payment is established.

Revenue arising from the use by others of enterprise resources yielding interest, royalties and dividends should only be recognized when no significant uncertainty as to measurability or collectability exists.

(Refer Illustration 4 & 5)

2.8 CONDITIONS FOR SALE OF GOODS

1. **Delivery is delayed at buyer's request and buyer takes title and accepts billing**

   Sometimes, the buyer may purchase goods and requests the seller to hold the goods on his behalf for some reason, for example, due to lack of storage or transportation delays. In such cases, the risks and rewards associated with the ownership seem to have been transferred to the buyer and the sale should be considered as complete. This is true even if the physical possession of the goodsis with the seller.

   The conditions to be met to account for the sale are:

   - the goods must be specifically identified, and cannot be transferred to another customer;
   - the delivery is delayed at buyer's request; and
   - the goods are ready to be delivered to the buyer

   Example 5

   XY Ltd sells goods worth Rs.50 lakh on 20 February 20X1 to AB Ltd. AB Ltd is facing storage capacity constraints at their warehouse. AB Ltd instructs XY Ltd to hold the goods at XY Ltd's warehouse and arrange for delivery on 15 March 20X1. However,all the risks and rewards associated with the sold goods are deemed transferred to AB Ltd.

   In the current scenario, delivery of goods sold is delayed at the request of buyer. XYLtd can recognize revenue for sale of goods to AB Ltd on 20 February 20X1 provided that the goods sold to AB Ltd are held in XY Ltd's warehouse separately and are not clubbed with other inventory.

2. **Sale on approval basis**

   Revenue should not be recognized until the goods have been formally accepted by the buyer or the buyer has done an act adopting the transaction or the time period for rejection has elapsed or where no time has been fixed, a reasonable time has elapsed.

   Example 6

   M/s XY sells goods worth Rs.5 lakh on 30th of March 20X1 to M/s FT under Sale on approval basis. Under the arrangement, FT can return the goods back to XY within next 3 months. XY cannot reasonably determine whether FT will give the acceptance of goods before the expiry of 3 months.

   Under these circumstances, XY cannot recognize revenue until the goods are accepted by FT or on completion of 3 months, whichever is earlier.

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3. **Goods sold subject to inspection / installation**

   In case the installation is complex and is significant to be able to use the goods in the intended manner, revenue should not be recognized until the installation is satisfactorily completed. However, in case the installation is simple (for example, a refrigerator needs to be plugged to a power connection after delivery to customer's place), revenue is recognized when the customer has agreed to purchase the goods.

4. **Sale and repurchase arrangement**

   Such arrangements are considered to be financing arrangement, and no sale can be recognized. Instead, a borrowing should be recognized in the books of theseller.

Example 7

On 1st January 20X1, M/s KJ sells goods at invoice value of Rs.5 lakhs to M/s TH. At the time of sale, M/s KJ has agreed to repurchase these goods back from M/s TH on 31st March at a price of Rs.6 Lac.

You are required to do the accounting for above transactions in the books of M/sKJ.

Solution

1st Jan 20X1:

Bank A/c	Dr.	Rs.5 lakhs	
To Loan from M/s TH A/c			Rs.5 lakhs
(Being borrowing made under the Sale &Repurchase arrangement)			

31st March 20X1

Interest expense A/c	Dr.	Rs.1 lakhs	
To Loan from M/s TH A/c			Rs.1 lakhs
(Being interest cost recognised on the borrowing)			

31st March 20X1:

Loan from M/s TH A/c	Dr.	Rs.6 lakhs	
To Bank A/c			Rs.6 lakhs
(Being repayment of loan taken from TH)			

5. **Trade discounts and volume rebates**

   Trade discounts and volume rebates received are not encompassed within the definition of revenue, since they represent a reduction of cost. Trade discounts and volume rebates given should be deducted in determining revenue.

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6. **Cash discounts**

Definition of revenue under AS 9 represents the gross inflow of cash from sale of goods or provision of services. Any cash discount given should not be deducted in determining the revenue. Revenue is therefore recognized at gross amount and cash discount is recorded as an expense as an when the seller receives the payment net of discount.

7. **Consignment Sale**

Consignment sales is a sale where a delivery is made whereby the recipient undertakes to sell the goods on behalf of the consignor.

In such case revenue should not be recognized until the goods are sold to a third party

Example 8

In the year 20X1-X2, XYZ supplied goods on Consignment basis to ABC – a retail outlet worth Rs.10,00,000. As per the terms, ABC will only pay XYZ for the goodswhich are sold by them to the third party. Rest of the goods can be returned back to XYZ and ABC will not have any further liability for these goods.

During the year 20X1-X2, ABC has sold goods worth Rs.5,50,000 only and rest of the goods are still lying in its store which may get sold by next year. Advise XYZ, how much revenue it can recognize in its books for period 20X1-X2.

Solution

As per AS 9, consignment risk and rewards are not transferred to the customer onjust delivery of the goods and no revenue should be recognized until the goods are sold to a third party. Therefore, XYZ can recognize revenue of Rs.5,50,000 only.

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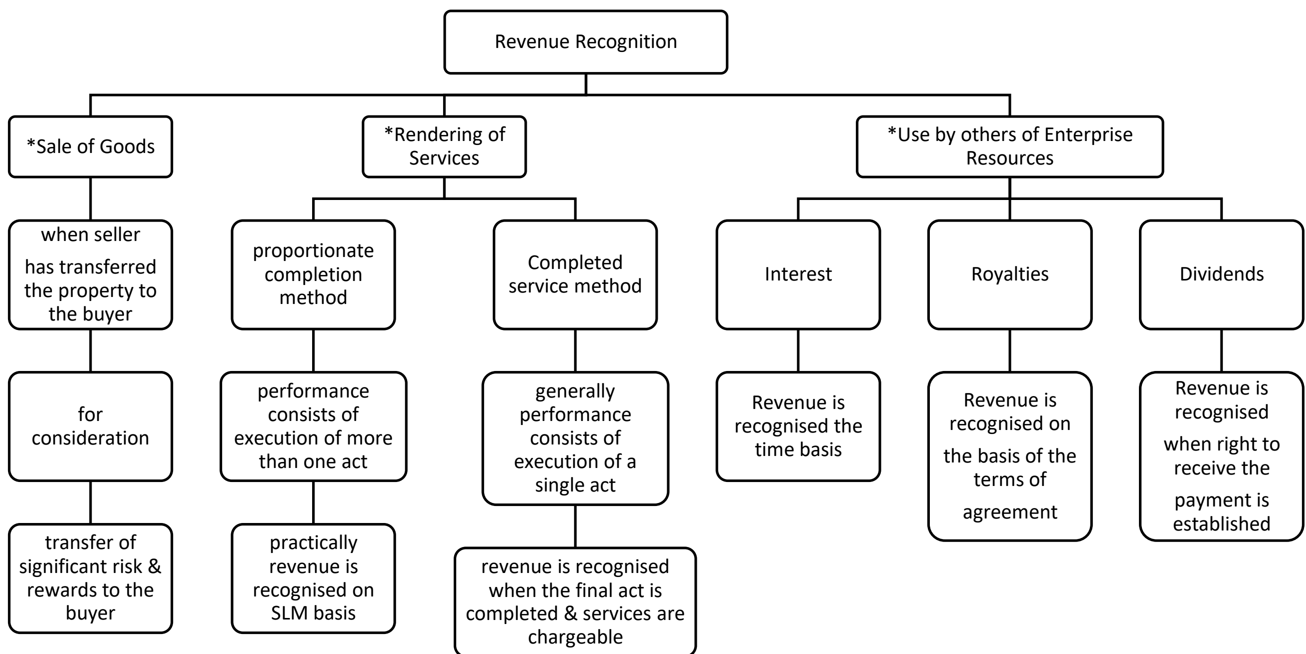
2.9 EFFECT OF UNCERTAINTIES ON REVENUE RECOGNITION

Where the ability to assess the ultimate collection with reasonable certainty is lacking at the time of raising any claim, revenue recognition is postponed to the extent of uncertainty involved.

When the uncertainty relating to collectability arises subsequent to the time of sale or the rendering of the service, it is more appropriate to make a separate provision to reflect the uncertainty rather than to adjust the amount of revenue originally recorded.

An essential criterion for the recognition of revenue is that the consideration receivable for the sale of goods, the rendering of services or from the use by others of enterprise resources is reasonably determinable. When such consideration is not determinable within reasonable limits, the recognition of revenue is postponed.



* Provided there exists <u>no significant uncertainty</u> regarding the ultimate collection of consideration (A key criterion for determining when to recognise revenue from a transactioninvolving the sale of goods is that the seller has transferred the property in the goods to the buyer for a consideration and there exists no significant uncertainty regarding the ultimate collection of consideration).

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2.10 DISCLOSURE

In addition to the disclosures required by AS 1 on 'Disclosure of Accounting Policies', an enterprise should disclose the circumstances in which revenue recognition has been postponed pending the resolution of significant uncertainties.

(Refer Illustration 6 & 7)

ILLUSTRATIONS

Illustration 1

Zigato runs a food-delivery business. As per the arrangement, Zigato allows customers to order food from local restaurants and is responsible the delivery of the food within stipulated time. During a particular year, it collects the money on orders made online as under:

Total price for the food item-	**Rs.200 lakhs**
Delivery charges -	**Rs.60 lakhs**
GST -	**Rs.40 lakhs**
Total -	**Rs.300 lakhs**

Zigato has received Rs.300 lakhs for the above orders from customers and the orders were delivered to the customer in stipulated time.

How much revenue should be recognised by restaurants and how much revenue should be recognised by Zigato for the year?

Solution

The risks and rewards associated with the food item are not with Zigato. When a customer has ordered a food item, whether the item will be prepared or not is the responsibility of the restaurant and not Zigato. Similarly, the responsibility to deliver the food item is with Zigato and the restaurant does not undertake responsibility for the same.

Therefore, the restaurant undertakes the principal's responsibility to prepare the food and ensure its quality. Zigato, on the other hand, is only responsible to deliver the food. Thus, Zigato is acting as an agent. Hence, it can only recognize revenue relating to that activity (which it does in the ordinary course of business). The revenue for Zigato, therefore, is Rs.60 lakhs, whereas, the revenue for restaurants will be Rs.200 lakhs.

It may be noted that the GST of Rs.40 lakhs is a liability payable to the Government (third party), hence it does not form part of revenue.

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Illustration 2

AB sells goods to CD on 1st March 20X1. CD is having significant cash flows issues since last few months. However, it is trying to raise funding through bank loan to be able to run its operations in future. On 5th of May 20X1, CD is able to seek the funding and is expected to be able to pay for the goods in future.

At the time of sale, it is difficult for AB to ascertain whether it will be able to collect the amount from CD due to poor financial conditions.

Explain how the recognition of revenue be done by AB?

Solution

In the above case, AB should not recognise any revenue on 1st of March and until that uncertainty of recovery is clear. Hence, the revenue can only be recognised by AB on 5th of May 20X1. The inventory transferred to CD until that date is required to be shown as its own inventory [inventory lying with customers].

Illustration 3

AB sells goods to CD on 1st January 20X1 for Rs.2 lakhs. After the sale was made, CD is having significant cash flows issues. It is trying to raise funding through bank loan to be able to run its operations in future. However, it is unable to do so and has gone under liquidation on 15th of March 20X1.

At the time of sale, there was no reason for AB to believe that it will not be able to collect the amount from CD in future.

Explain how the recognition of revenue be done by AB for the year ended 31st March 20X1?

Solution

In the above case, at the time of sale, it was not unreasonable for AB to expect ultimate collection from CD. Therefore, AB should recognise the revenue of Rs.2 lakhs on 1st of January 20X1 and recognise a receivable for the same amount. Later, since CD went into liquidation, AB should write off the receivables and book a loss in his books.

Accounting in the books of AB

1st January 20X1

CD A/c (Receivables) To Revenue A/c (Being goods sold to CD Ltd)	Dr.	Rs.2 lakhs	 Rs.2 lakhs

15th March 20X1

Bad Debts A/c To CD A/c (Receivables)A/c (Being receivables from CD written off due to its liquidation)	Dr.	Rs.2 lakhs	 Rs.2 lakhs

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Illustration 4

During the year ended 31st March 20X1, ZX Enterprises has recognized Rs.100 lakhs on accrual basis income from dividend on units of mutual funds held by it. The dividends on mutual funds were declared on 15th June, 20X1. The dividend was proposed on 10th April, 20X1. Whether the above treatment is as per the relevant Accounting Standard?

Solution

Dividends from investments in shares are not recognized in the statement of profit and loss until a right to receive payment is established. In the given situation, the dividend is proposed on 10th April, 20X1, while it is declared on 15th June, 20X1. Thus, the right to receive the payment of dividend gets established on 15th June, 20X1.

The recognition of Rs.100 lakhs on accrual basis in the financial year 20X0-20X1 is not correct as per AS 9 'Revenue Recognition'.

Illustration 5

Y Ltd., used certain resources of X Ltd. In return X Ltd. received Rs.10 lakhs and Rs.15 lakhs as interest and royalties respective from Y Ltd. during the year 20X1-X2. You are required to state whether and on what basis these revenues can be recognized by X Ltd.

Solution

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As per AS 9 on Revenue Recognition, revenue arising from the use by others of enterprise resources yielding interest and royalties should only be recognized when no significant uncertainty as to measurability or collectability exists. These revenues are recognized on the following bases:

i. **Interest:** on a time proportion basis taking into account the amount outstanding and the rate applicable. Therefore X Ltd. should recognize interest revenue of Rs.10 Lakhs

ii. **Royalties**: on an accrual basis in accordance with the terms of the relevant agreement. X Ltd. therefore should recognize royalty revenue of Rs.15 Lakhs.

Illustration 6

The Board of Directors decided on 31.3.20X2 to increase the sale price of certain items retrospectively from 1st January, 20X2. In view of this price revision with effect from 1st January 20X2, the company has to receive Rs.15 lakhs from its customers in respect of sales made from 1st January, 20X2 to 31st March, 20X2.

Accountant cannot make up his mind whether to include Rs.15 lakhs in the sales for20X1-20X2.Advise.

Solution

Price revision was effected during the current accounting period 20 X1-20X2. As a result, the company stands to receive Rs.15 lakhs from its customers in respect of sales made from 1st January, 20X2 to 31st March, 20X2. If the company is able to assess the ultimate collection with reasonable certainty, only then additional revenue arising out of the said price revision may be recognized in 20X1-20X2.

If the company is not reasonably certain on ultimate collection Rs.15 lakhs from its customers in respect of sales made from 1st January, 20X2 to 31st March, 20X2, it shall postpone recognition of revenue and disclose it in financial statements for year 20X1-20X2 as per AS 1

Illustration 7

A claim lodged with the Railways in March, 20X1 for loss of goods of Rs.2,00,000 had been passed for payment in March, 20X3 for Rs.1,50,000. No entry was passed in the books of the Company, when the claim was lodged. Advise P Co. Ltd. about the treatment of the following in the Final Statement of Accounts for the year ended31st March, 20X3.

Solution

AS 9 on 'Revenue Recognition' states that where the ability to assess the ultimate collection with reasonable certainty is lacking at the time of raising any claim, revenue recognition is postponed to the extent of uncertainty involved. When recognition of revenue is postponed due to the effect of uncertainties, it is considered as revenue of the period in which it is certain to be collected. In this case it may be assumed that collectability of claim was not certain in the earlier periods. This is supposed from the fact that only Rs.1,50,000 were collected against a claim of Rs.2,00,000. So this transaction can not be taken as a Prior Period Item.

Hence receipt of Rs.1,50,000 shall be recognized as revenue in year ended 31st March, 20X3

In the light of AS 5, it will not be treated as extraordinary item. However, AS 5 states that when items of income and expense within profit or loss from ordinary activities are of such size, nature, or incidence that their disclosure is relevant to explain the performance of the enterprise for the period, the nature and amount of such items should be disclosed separately.

Accordingly, the nature and amount of this item should be disclosed separately.

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<u>TEST YOUR KNOWLEDGE</u>

MCQs

1. **Which of the conditions mentioned below must be met to recognize <u>revenue from the sale of goods</u>?**
   - i. **the entity selling does not retain any continuing influence or controlover the goods;**
   - ii. **when the goods are dispatched to the buyer;**
   - iii. **revenue can be measured reliably;**
   - iv. **the supplier is paid for the goods;**
   - v. **it is reasonably certain that the buyer will pay for the goods;**
   - vi. **the buyer has paid for the goods.**
   - a. **i., ii. and v.**
   - b. **ii., iii. and iv.**
   - c. **i., iii. and v.**
   - d. **i., iv. and v.**

2. **Consignment inventory is an arrangement whereby inventory is held by one party but owned by another party. Which of the following indicates that the inventory in question is a consignment inventory?**
   - a. **Manufacturer cannot require the dealer to return the inventory**
   - b. **Dealer has the right to return the inventory**
   - c. **Manufacture is responsible for the pricing of goods and any changes inthe pricing can only be approved by the manufacturer.**
   - d. **Manufacture is responsible for the holding the goods and any changesin the pricing can only be approved by the dealer**

3. **Which of the following transactions <u>qualify as revenue</u> for M/s AB Enterprises?**
   - a. **Sales of Rs.20 lakhs made under consignment sales.**
   - b. **Sale of an old machine amounting Rs.5 lakhs**
   - c. **Services provided to the customer in the normal course of business. Sales recorded is Rs.50,000.**
   - d. **Sales of Rs.25 lakhs made under consignment sales**

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4. **The Accounting Club has 100 members who are required to pay an annual membership fee of Rs.5,000 each. During the current year, all members havepaid the fee. However, 5 members have paid an amount of Rs.10,000 each. Of these, 3 members paid the current year's fee and also the previous year's dues. Remaining 2 members have paid next years' fee of Rs.5,000 in advance.**

   Revenue from membership fee for the current year to be recognised will be:

   a. **Rs.5,25,000**
   b. **Rs.5,10,000**
   c. **Rs.5,00,000**
   d. **Rs.5,15,000**

5. **Flix Net International offers a subscription fee model to allow the paid subscribers an annual viewing of movies, sports events and other content. It allows users to register for free and have access to limited content for onemonth without any charges. The customer has a right to cancel thesubscription within a month's time but is required to pay for 1 year subscription fee after the free period.**

   XY has subscribed for free viewing on 1st March 20X1. After 1 month, he has agreed to pay the annual membership and has paid Rs.1,200 on 31st March20X1 for the subscription that is valid up to 31st of March 20X2.

   Revenue that can be recognized by Flix Net for the year ended 31st March 20X2 is

   a. **Rs.100**
   b. **Rs.1,200**
   c. **Nil**
   d. **Rs.1,100**

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ANSWERS/SOLUTIONS

1.	**a.**	i., ii. and v.
2.	**c.**	Manufacture is responsible for the pricing of goods and any changes in the pricing can only be approved by the manufacturer.
3.	**c.**	Services provided to the customer in the normal course of business. Sales recorded is Rs.50,000.
4.	**c.**	Rs.5,00,000
5.	**b.**	Rs.1,200

PRACTICAL QUESTIONS

Q.NO.1. GH manufactures and sells televisions. The televisions are shipped to the customer by sea. In order to transfer risk related to the shipment of the televisions, GH also gets an insurance coverage for the goods while they are in transit from the factory to customer's location.

The insurance policy will reimburse GH for the value of the goods in the event of loss or damage arising anytime up to these goods reaching customer's location. The legal title passes when the goods arrive at the customer's premises one month later.

When should Entity GH recognize revenue in its books?

SOLUTION

GH should recognize revenue for the sale when the goods arrive at the customer's premises. GH has not transferred the televisions' significant risks and rewards of ownership to the customer when the goods depart from the factory. This is evidenced by the fact that any insurance proceeds received from the goods' damage or destruction will be repaid to GH. Further, the legal title does not pass until the goods arrive at the customer's premises.

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Q.NO.2. The following information of Meghna Ltd. is provided:

i. **Goods of Rs.60,000 were sold on 20-3-20X2 but at the request of the buyer these were delivered on 10-4-20X2.**
ii. **On 15-1-20X2 goods of Rs.1,50,000 were sent on consignment basis of which 20% of the goods unsold are lying with the consignee as on 31-3-20X2.**
iii. **Rs.1,20,000 worth of goods were sold on approval basis on 1 -12-20X1. The period of approval was 3 months after which they were considered sold. Buyer sent approval for 75% goods up to 31-1-20X2 and no approval or disapproval received for the remaining goods till 31 -3- 20X2.**
iv. **Apart from the above, the company has made cash sales of Rs.7,80,000 (gross). Trade discount of 5% was allowed on the cash sales.**

You are required to advise the accountant of Meghna Ltd., with valid reasons,the amount to be recognized as revenue in above cases in the context of AS 9.

SOLUTION

As per AS 9 "Revenue Recognition", in a transaction involving the sale of goods, performance should be regarded as being achieved when the following conditions are fulfilled:

i. the seller of goods has transferred to the buyer the property in the goods for a price or all significant risks and rewards of ownership have been transferred to the buyer and the seller retains no effective control of the goods transferred to a degree usually associated with ownership; and

ii. no significant uncertainty exists regarding the amount of the consideration that will be derived from the sale of the goods.

Case (i) The sale is complete but delivery has been postponed at buyer's request. The entity should recognize the entire sale of Rs.60,000 for the year ended 31st March, 20X2.

Case (ii) 20% goods lying unsold with consignee should be treated as closing inventory and sales should be recognized for Rs.1,20,000 (80% of Rs.1,50,000). In case of consignment sale revenue should not be recognized until the goods are sold to a third party.

Case (iii) In case of goods sold on approval basis, revenue should not be recognized until the goods have been formally accepted by the buyer or the buyer has done an act adopting the transaction or the time period for rejection has elapsed or where no time has been fixed, a reasonable time has elapsed. Therefore, revenue should be recognized for the Rs.90,000 upon receipt of approval on 31-02-20X1 and for the balance Rs.30,000 on 01-03- 20X1 as the time period for rejecting the goods had expired.

Case (iv) Trade discounts given should be deducted in determining revenue. Thus Rs.39,000 should be deducted from the amount of turnover of Rs.7,80,000 for the purpose of recognition of revenue. Thus, revenue should be Rs.7,41,000.

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Q.NO.3. For the year ended 31st March 20X1, KY Enterprises has entered into the following transactions. On 31 March 20X1, KY supplied two machines to its customer ST. Both machines were accepted by ST on 31 March 20X1. Machine 1 was a machine that was routinely supplied by KY to many customers and the installation process was very simple. Machine 1 was installed on 2 April 20X1 by ST's employees. Machine 2 being more specialised in nature requires an installation process which is more complicated, requiring significant assistance from KY. Machine 2 was installed between 2 and 5 April 20X1. Details of costs and sales prices are as follows:

	Machine 1	**Machine 2**
Sale Price	3,20,000	3,00,000
Cost of production	1,60,000	1,50,000
Installation fee	nil	10,000

How should above transactions be recognized by KY Enterprises for theyear ended 31st March 20X1?

SOLUTION

Machine 1: As the installation process is simple, revenue from Machine 1 will be recognized on 31 March 20X1.

Revenue (Machine 1)	Rs.3,20,000
Cost of Goods Sold	Rs.1,60,000
Profit during the period	Rs.1,60,000

Since the question specifies that the machine is already accepted by ST on 31 March 20X1, the revenue arising from sale of the machine needs to be recognized for the year ending 31 March 20X1. This is because acceptance of the machine indicates that the risks and rewards pursuant to the ownership are transferred to ST.

Machine 2: Installation process for Machine 2 is more complicated, requiring significant assistance from KY Ltd. However, question specifies that the machine is already accepted by ST on 31 March 20X1. Assuming that there is no further approval/acceptance required from the buyer for the Machine sold, revenue from sale of Machine 2 can be recognized for the year ending 31 March 20X1.

Revenue (Machine 2)	Rs.3,00,000
Cost of Goods Sold	Rs.1,50,000
Profit during the period	Rs.1,50,000

However, installation fee which is for rendering installation services cannot be recognized until the installation is complete. Since the machine is pending installation, the revenue in respect of installation charges Rs.10,000 needs to be recognized on 5 April 20X1 once the installation process gets completed.

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9. OTHER ACCOUNTING STANDARDS

UNIT 1: ACCOUNTING STANDARD 12: ACCOUNTING FOR GOVERNMENT GRANT

LEARNING OUTCOMES

After studying this unit, you will be able to comprehend the –

- Accounting Treatment of Government Grants
- Capital Approach versus Income Approach
- Recognition of Government Grants
- Non-monetary Government Grants
- Presentation of Grants:
    - Related to Specific Fixed Assets
    - Related to Revenue
    - In the nature of Promoters' contribution
- Refund of Government Grants
- Disclosures.

1.1. INTRODUCTION

AS 12 deals with accounting for government grants such as subsidies, cash incentives, duty drawbacks, etc. and specifies that the government grants should not be recognised until there is reasonable assurance that the enterprise will comply with the conditions attached to them, and the grant will be received.

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The standard also describes the treatment of non-monetary government grants; presentation of grants related to specific fixed assets and revenue and those in the nature of promoters' contribution; treatment for refund of government grants etc.

This Standard does not deal with:

i. The special problems arising in accounting for government grants in financial statements reflecting the effects of changing prices or in supplementary information of a similar nature.

ii. Government assistance other than in the form of government grants.

iii. Government participation in the ownership of the enterprise.

The receipt of government grants by an enterprise is significant for preparation of the financial statements for two reasons. Firstly, if a government grant has been received, an appropriate method of accounting therefore is necessary. Secondly, it is desirable to give an indication of the extent to which the enterprise has benefited from such grant during the reporting period. This facilitates comparison of an enterprise's financial statements with those of prior periods and with those of other enterprises.

1.2 GOVERNMENT GRANTS

Government grants are assistance by government in cash or kind to an enterprise for past or future compliance with certain conditions. They exclude those forms of government assistance which cannot reasonably have a value placed upon them and transactions with government which cannot be distinguished from the normal trading transactions of the enterprise.

1.3 ACCOUNTING TREATMENT OF GOVERNMENT GRANTS

Two broad approaches may be followed for the accounting treatment of government grants:

- the 'capital approach', under which a grant is treated as part of shareholders' funds, and
- the 'income approach', under which a grant is taken to income over one or more periods.

It is generally considered appropriate that accounting for government grant should be based on the nature of the relevant grant. Grants which have the characteristics similar to those of promoters' contribution should be treated as part of shareholders' funds. Income approach may be more appropriate in the case of other grants.

1.4 RECOGNITION OF GOVERNMENT GRANTS

A government grant is not recognised until there is reasonable assurance that:

- the enterprise will comply with the conditions attaching to it; and
- the grant will be received.

Receipt of a grant is not of itself conclusive evidence that the conditions attaching to the grant have been or will be fulfilled.

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Example:

X Ltd applies for a grant from the local authority towards a social cause. X Ltd. is required to meet certain conditions to be eligible for the receipt of grant. There is a reasonable assurance that X Ltd will receive the grant in time. However, after having applied for the grant, there is a likelihood that X Ltd may not be able to meet all the conditions attached to the grant.

In such case, X Ltd should not recognise the grant in its books until there is a reasonable assurance that it would be able to meet all conditions attached to the grant.

1.5 NON-MONETARY GOVERNMENT GRANTS

Government grants may take the form of non-monetary assets, such as land or other resources, given at concessional rates. In these circumstances, it is usual to account for such assets at their acquisition cost. Non-monetary assets given free of cost are recorded at a nominal value.

Example

X Convent wishes to open a school in locality A. It applies to the State authority for grant of land. The State authority grants the land for construction of the purposes of the school construction. The market value of the land is Rs.20 crore whereas however, the authority provides the land at a nominal cost of Rs.50 lakhs including cost of registration. The State authority requires that free education must be provided to the poor children by way of reserving 20% of the seats in the school for such children. There is a reasonable assurance that X Convent has a reason to believe it can will meet that the above stated condition attached to the grant.

Thus, X Convent needs to would recognise the cost of the land at its acquisition cost of Rs.50 lakhs.

1.6 PRESENTATION OF GRANTS RELATED TO SPECIFIC FIXED ASSETS

Grants related to specific fixed assets are government grants whose primary condition is that an enterprise qualifying for them should purchase, construct or otherwise acquire such assets. Other conditions may also be attached restricting the type or location of the assets or the periods during which they are to be acquired or held.

Example

The Central Government is planning to generate large employment in rural and backward regions. Thus, it is planning to give grants for the same to entities who will meet the required conditions. F Ltd applied for a grant to the Central Government. The Government will give the grant on the condition that, F Ltd will be required to construct a factory where it would need to employ at least 500 workers for 5 years. Total cost of the construction is expected to be Rs.50 crore. The amount of the grant is Rs.30 crore.

F Ltd will be able to recognise the grant only if there is reasonable assurance that it will meet o the condition of employing 500 workers for next 5 years.

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

Method I:

- The grant is shown as a deduction from the gross value of the asset concerned in arriving at its book value.
- The grant is thus recognised in the profit and loss statement over the useful life of a depreciable asset by way of a reduced depreciation charge.
- Where the grant equals the whole, or virtually the whole, of the cost of the asset, the asset is shown in the balance sheet at a nominal value. **(Refer Illustration 1)**

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Method II:

- Grants related to depreciable assets are treated as deferred income which is recognised in the profit and loss statement on a systematic and rational basis over the useful life of the asset.
- Grants related to non-depreciable assets are credited to capital reserve under this method, as there is usually no charge to income in respect of such assets.
- If a grant related to a non-depreciable asset requires the fulfilment of certain obligations, the grant is credited to income over the same period over which the cost of meeting such obligations is charged to income.

(Refer Illustration 2 & 3)

1.7 PRESENTATION OF GRANTS RELATED TO REVENUE

Grants related to revenue are sometimes presented as a credit in the profit and loss statement, either separately or under a general heading such as 'Other Income'. Alternatively, they are deducted in reporting the related expense.

(Refer Illustration 4)

a.

Particulars	Rs.(Dr.)	Rs.(Cr.)
Bank Account Dr.	90,00,000	
To Deferred Income Account		90,00,000
(Being receipt of grant from government)		
Salary Expense Account Dr.	12,00,000	
To Bank Account		12,00,000
(Being Salary expense paid (net of grant income) for the year)		
Deferred Income Account Dr.	18,00,000	
To Salary Expense Account		18,00,000
(Being Year 1 grant adjusted against Salary expense for the year		

1.8 PRESENTATION OF GRANTS OF THE NATURE OF PROMOTERS' CONTRIBUTION

Where the government grants are of the nature of promoters' contribution, i.e., they are given with reference to the total investment in an undertaking or by way of contribution towards its total capital outlay (for example, central investment subsidy scheme) and no repayment is ordinarily expected in respect thereof, the grants are treated as capital reserve which can be neither distributed as dividend nor considered as deferred income.

(Refer Illustration 5 & 6)

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1.9 REFUND OF GOVERNMENT GRANTS

- Government grants sometimes become refundable because certain conditions are not fulfilled and are treated as an **extraordinary item** (AS 5).
- The amount refundable in respect of a government grant related to revenue is applied first against any unamortised deferred credit remaining in respect of the grant. To the extent that the amount refundable exceeds any such deferred credit, or where no deferred credit exists, the amount is charged immediately to profit and loss statement.
- The amount refundable in respect of a government grant related to a specific fixed asset is recorded by increasing the book value of the asset or by reducing the deferred income balance, as appropriate, by the amount refundable. In the first alternative, i.e., where the book value of the asset is increased, depreciation on the revised book value is provided prospectively over the residual useful life of the asset.
- Where a grant which is in the nature of promoters' contribution becomes refundable, in part or in full, to the government on non fulfillment of some specified conditions, the relevant amount recoverable by the government is reduced from the capital reserve.

1.10 DISCLOSURE

i. The accounting policy adopted for government grants, including the methods of presentation in the financial statements;

ii. The nature and extent of government grants recognised in the financial statements, including grants of non-monetary assets given at a concessional rate or free of cost.

(Refer Illustration 7 - 11)

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ILLUSTRATIONS

Illustration 1

Z Ltd. purchased a fixed asset for Rs.50 lakhs, which has the estimated useful life of 5 years with the salvage value of Rs.5,00,000. On purchase of the assets government granted it a grant for Rs.10 lakhs. Pass the necessary journal entries in the books of the company for first two years if the grant amount is deducted from the value of fixed asset.

Solution

Journal in the books of Z Ltd.

Year	Particulars	Rs.(Dr.)	Rs.(Cr.)
1st	Fixed Assets Account Dr.	50,00,000	
	To Bank Account		50,00,000
	(Being Fixed Assets purchased)		
	Bank Account Dr.	10,00,000	
	To Fixed Assets Account		10,00,000
	(Being grant received from the government)		
	Depreciation Account Dr.	7,00,000	
	To Fixed Assets Account		7,00,000
	(Being Depreciation charged on SLM)		
	Profit & Loss Account Dr.	7,00,000	
	To Depreciation Account		7,00,000
	(Being Depreciation transferred to P&L Account)		
2nd	Depreciation Account Dr.	7,00,000	
	To Fixed Assets Account		7,00,000
	(Being Depreciation charged on SLM)		
	Profit & Loss Account Dr.	7,00,000	
	To Depreciation Account		7,00,000
	(Being Depreciation transferred to P&L Account)		

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Illustration 2

Z Ltd. purchased a fixed asset for Rs.50 lakhs, which has the estimated useful life of 5 years with the salvage value of Rs.5,00,000. On purchase of the assets government granted it a grant for Rs.10 lakhs. Pass the necessary journal entries in the books of the company for first two years if the grant is treated as deferred income.

Solution

Journal in the books of Z Ltd.

Year	Particulars		Rs.(Dr.)	Rs.(Cr.)
1st	Fixed Assets Account	Dr.	50,00,000	
	To Bank Account			50,00,000
	(Being Fixed Assets purchased)			
	Bank Account	Dr.	10,00,000	
	To Fixed Assets Account			10,00,000
	(Being grant received from the government)			
	Depreciation Account	Dr.	9,00,000	
	To Fixed Assets Account			9,00,000
	(Being Depreciation charged on SLM)			
	Profit & Loss Account	Dr.	9,00,000	
	To Depreciation Account			9,00,000
	(Being Depreciation transferred to P&L Account)			
	Deferred Government Grants Account	Dr.	2,00,000	
	To Profit & Loss Account			2,00,000
	(Being proportionate government grant taken to P/L			
2nd	Depreciation Account	Dr.	9,00,000	
	To Fixed Assets Account			9,00,000
	(Being depreciation charged on SLM)			
	Profit & Loss Account	Dr.	9,00,000	
	To Depreciation Account			9,00,000
	(Being depreciation transferred to P/L Account)			
	Deferred Government Grant Account	Dr.	2,00,000	
	To Profit & Loss Account			2,00,000
	(Being proportionate government grant taken to P/L			

Illustration 3

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

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Solution

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

In the second case, even if the company has not spent money for the acquisition of land, land should be recorded in the books of accounts at a nominal value. The treatment of both the elements of the grant is incorrect as per AS 12.

Illustration 4

Co X runs a charitable hospital. It incurs salary of doctors, staff etc to the extent of Rs.30 lakhs per annum. As a support, the local govt grants a lump sum payment of Rs.90 lakhs to meet the salary expense for a period of next 5 years.

You are required to pass the necessary journal entries in the books of the company for first year if the grant is:

a. Shown separately as Other Income; and

b. Deducted against the Salary costs.

Solution

a.

Particulars		Rs.(Dr.)	Rs.(Cr.)
To Bank Account	Dr.	90,00,000	
To Deferred Income Account			90,00,000
(Being receipt of grant from government)			
Salary Expense Account	Dr.	30,00,000	
To Bank Account			30,00,000
(Being Salary expense paid for the year)			
Deferred Income Account	Dr.	18,00,000	
To Other Income Account			18,00,000
(Being Year 1 Grant income recognised in Profit & Loss)			

Note: The grant has been spread on a straight-line basis over a period of 5 years [Rs.90,00,000/5 years = Rs.18,00,000].

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b.

Particulars		Rs.(Dr.)	Rs.(Cr.)
To Bank Account	Dr.	90,00,000	
To Deferred Income Account			90,00,000
(Being receipt of grant from government)			
Salary Expense Account	Dr.	12,00,000	
To Bank Account			12,00,000
(Being Salary expense paid (net of grant income) for the year)			
Deferred Income Account	Dr.	18,00,000	
To Salary Expense Account			18,00,000
(Being Year 1 Grant income recognised in Profit & Loss)			

Illustration 5

Top & Top Limited has set up its business in a designated backward area which entitles the company to receive from the Government of India a subsidy of 20% of the cost of investment, for which no repayment was ordinarily expected. Moreover, there was no condition that the company should purchase any specified assets for this subsidy. Having fulfilled all the conditions under the scheme, the company on its investment of Rs.50 crore in capital assets received Rs.10 crore from the Government in January, 20X2 (accounting period being 20X1-20X2). The company wants to treat this receipt as an item of revenue and thereby reduce the losses on profit and loss account for the year ended 31st March, 20X2.

Keeping in view the relevant Accounting Standard, discuss whether this action is justified or not.

Solution

As per para 10 of AS 12 'Accounting for Government Grants', where the government grants are of the nature of promoters' contribution, i.e. they are given with reference to the total investment in an undertaking or by way of contribution towards its total capital outlay (for example, central investment subsidy scheme) and no repayment is ordinarily expected in respect thereof, the grants are treated as capital reserve which can be neither distributed as dividend nor considered as deferred income.

In the given case, the subsidy received is neither in relation to specific fixed asset nor in relation to revenue. Thus, it is inappropriate to recognise government grants in the profit and loss statement, since they are not earned but represent an incentive provided by government without related costs. The correct treatment is to credit the subsidy to capital reserve. Therefore, the accounting treatment desired by the company is not proper.

Illustration 6

How would you treat the following in the accounts in accordance with AS 12 'Government Grants'?

i. **Rs.35 Lakhs received from the Local Authority for providing medical facilities to the employees.**
ii. **Rs.100 Lakhs received as Subsidy from the Central Government for setting up a unit in notified backward area. This subsidy is in nature of promoters' contribution.**

Solution

i. Rs.35 lakhs received from the local authority for providing medical facilities to the employees is a grant received in nature of revenue grant. Such grants are generally presented as a credit in the profit and loss statement, either separately or under a general heading such as 'Other Income'. Alternatively, Rs.35 lakhs may be deducted in reporting the related expense i.e. employee benefit expenses.

ii. As per AS 12 'Accounting for Government Grants', where the government grants are in the nature of promoters' contribution, i.e. they are given with reference to the total investment in an undertaking or by way of contribution towards its total capital outlay and no repayment is ordinarily expected in respect thereof, the grants are treated as capital reserve which can be neither distributed as dividend nor considered as deferred income. In the given case, the subsidy received from the Central Government for setting up a unit in notified backward area is neither in relation to specific fixed asset nor in relation to revenue. Thus, amount of Rs.100 lakhs should be credited to capital reserve.

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Illustration 7

Z Ltd. purchased a fixed asset for Rs.50 lakhs, which has the estimated useful life of 5 years with the salvage value of Rs.5,00,000. On purchase of the assets government granted it a grant for Rs.10 lakhs (This amount was reduced from the cost of fixed asset). Grant was considered as refundable in the end of 2nd year to the extent of Rs.7,00,000. Pass the journal entry for refund of the grant as per the first method.

Solution

Particulars	Rs.(Dr.)	Rs.(Cr.)
Fixed Assets Account Dr. To Bank Account (Being government grant on asset refunded)	Rs.7,00,000	 Rs.7,00,000

Illustration 8

A fixed asset is purchased for Rs.20 lakhs. Government grant received towards it is Rs.8 lakhs. Residual Value is Rs.4 lakhs and useful life is 4 years. Assume depreciation on the basis of Straight Line method. Asset is shown in the balance sheet net of grant. After 1 year, grant becomes refundable to the extent of Rs.5 lakhs due to non compliance with certain conditions. Pass journal entries for first two years.

Solution

Journal Entries

Year	Particulars		Rs.in lakhs (Dr.)	Rs.in lakhs (Cr.)
1	Fixed Asset Account To Bank Account (Being fixed asset purchased)	Dr.	20	 20
	Bank Account To Fixed Asset Account (Being grant received from the government reduced the cost of fixed asset)	Dr.	8	 8
	Depreciation Account (W.N.1) To Fixed Asset Account (Being depreciation charged on Straight Line method (SLM))	Dr.	2	 2
	Profit & Loss Account To Depreciation Account (Being depreciation transferred to Profit and Loss Account at the end of year 1)	Dr.	2	 2
2	Fixed Asset Account To Bank Account (Being government grant on asset partly refunded which increased the cost of fixed asset)	Dr.	5	 5
	Depreciation Account (W.N.2) To Fixed Asset Account (Being depreciation charged on SLM on revised value of fixed asset prospectively)	Dr.	3.67	 3.67

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	Profit & Loss Account	Dr.	3.67	
	To Depreciation Account			3.67
	(Being depreciation transferred to Profit and Loss Account at the end of year 2)			

Working Notes:

1. **Depreciation for Year 1**

	Rs.in lakhs
Cost of the Asset	20
Less: Government grant received	(8)
	12
Depreciation $\left[\frac{12-4}{4}\right]$	2

2. **Depreciation for Year 2**

	Rs.in lakhs
Cost of the Asset	20
Less: Government grant received	(8)
	12
Less: Depreciation for the first year $\left[\frac{12-4}{4}\right]$	2
	10
Add: Government grant refundable	5
	15
Depreciation for the second year $\left[15-\frac{4}{3}\right]$	3.67

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Illustration 9

On 1.4.20X1, ABC Ltd. received Government grant of Rs.300 lakhs for acquisition of machinery costing Rs.1,500 lakhs. The grant was credited to the cost of the asset. The life of the machinery is 5 years. The machinery is depreciated at 20% on WDV basis. The Company had to refund the grant in May 20X4 due to non-fulfilment of certain conditions.

How you would deal with the refund of grant in the books of ABC Ltd. assuming that the company did not charge any depreciation for year 20X4?

Solution

According to para 21 of AS 12 on Accounting for Government Grants, the amount refundable in respect of a grant related to a specific fixed asset should be recorded by increasing the book value of the asset or by reducing deferred income balance, as appropriate, by the amount refundable. Where the book value is increased, depreciation on the revised book value should be provided prospectively over the residual useful life of the asset.

		(Rs.in lakhs)
1st April, 20X1	Acquisition cost of machinery (Rs.1,500 – Rs.300)	1,200.00
	Less: Depreciation @ 20%	(240.00)
31st March, 20X2	Book value	960.00
	Less: Depreciation @ 20%	(192.00)
31st March, 20X3	Book value	768.00
	Less: Depreciation @ 20%	(153.60)
31st March, 20X4	Book value	614.40
1st April, 20X4	Add: Refund of grant	300.00
May, 20X4	Revised book value	914.40

Depreciation @ 20% on the revised book value amounting Rs.914.40 lakhs is to be provided prospectively over the residual useful life of the asset.

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Illustration 10

A Ltd. purchased a machinery for Rs.40 lakhs. (Useful life 4 years and residual value Rs.8 lakhs) Government grant received is Rs.16 lakhs. Show the Journal Entry to be passed at the time of refund of grant in the third year and the value of the fixed assets, if:

1. **the grant is credited to Fixed Assets A/c.**
2. **the grant is credited to Deferred Grant A/c.**

Solution

In the books of A Ltd. Journal Entries (at the time of refund of grant)

1. **If the grant is credited to Fixed Assets Account:**

		Rs.	**Rs.**
Fixed Assets A/c	Dr.	16 lakhs	
To Bank A/c			16 lakhs
(Being grant refunded)			

The balance of fixed assets after two years depreciation will be Rs.16 lakhs (W.N.1) and after refund of grant it will become (Rs.16 lakhs + Rs.16 lakhs) = Rs.32 lakhs on which depreciation will be charged for remaining two years. Depreciation = (32-8)/2 = Rs.12 lakhs p.a. will be charged for next two years.

2. **If the grant is credited to Deferred Grant Account:**

As per para 14 of AS 12 'Accounting for Government Grants,' income from Deferred Grant Account is allocated to Profit and Loss account usually over the periods and in the proportions in which depreciation on related assets is charged. Accordingly, in the first two years (Rs.16 lakhs /4 years) = Rs.4 lakhs p.a. x 2 years = Rs.8 lakhs were credited to Profit and Loss Account and Rs.8 lakhs was the balance of Deferred Grant Account after two years.

		Rs.	**Rs.**
Deferred Grant A/c	Dr.	8 lakhs	
Profit & Loss A/c	Dr.	8 lakhs	
To Bank A/c			16 lakhs
(Being Government grant refunded)			

Therefore, on refund in the 3rd year, following entry will be passed:

Deferred grant account will become Nil. The fixed assets will continue to be shown in the books at Rs.24 lakhs (W.N.2) and depreciation will continue to be charged at Rs.8 lakhs per annum for the remaining two years

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Working Notes:

1. **Balance of Fixed Assets after two years but before refund (under first alternative)**

Fixed assets initially recorded in the books = Rs.40 lakhs – Rs.16 lakhs = Rs.24 lakhs

Depreciation p.a. = (Rs.24 lakhs – Rs.8 lakhs)/4 years = Rs.4 lakhs per year

Value of fixed assets after two years but before refund of grant

= Rs.24 lakhs – (Rs.4 lakhs x 2 years) = Rs.16 lakhs

2. **Balance of Fixed Assets after two years but before refund (under second alternative)**

Fixed assets initially recorded in the books = Rs.40 lakhs

Depreciation p.a. = (Rs.40 lakhs – Rs.8 lakhs)/4 years = Rs.8 lakhs per year

Book value of fixed assets after two years = Rs.40 lakhs – (Rs.8 lakhs x 2 years) = Rs.24 lakhs

Note: Value of fixed assets given above is after refund of government grant.

Illustration 11

Co X runs a charitable hospital. It incurs salary of doctors, staff etc to the extent of Rs.30 lakhs per annum. As a support, the local Govt. grants a lumpsum payment of Rs.90 lakhs to meet the salary expense for a period of next 5 years.

At the start of Year 4, Co X is unable to meet the conditions attached to the grant and is required to refund the entire grant of 90 lakhs.

You are required to pass the necessary journal entries in the books of the company for refund of the grant if the grant was shown separately as Other Income.

Solution

		Rs.	Rs.
Deferred Grant A/c	Dr.	36 lakhs	
Profit & Loss A/c	Dr.	54 lakhs	
To Bank A/c			90 lakhs
(Being Government grant refunded)			

Workings:

Total grant received: Rs.90 Lakhs

Grant recognised as income for first 3 years: Rs.18 lakhs × 3

= Rs.54 lakhs

Remaining Deferred Income = Rs.90 Lakhs – 54 lakhs

= Rs.36 lakhs

Reference: The students are advised to refer the full text of AS 12 “Accounting for Government Grants”.

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TEST YOUR KNOWLEDGE

MCQs

1. **To encourage industrial promotion, IDCI offers subsidy worth Rs.50 lakhs to all new industries set up in the specified industrial areas. This grant is in the nature of promoter's contribution. How such subsidy should be accounted in the books?**
   a. **Credit it to capital reserve**
   b. **Credit it as 'other income' in the profit and loss account in the year of commencement of commercial operations**
   c. **Both a. and b. are permitted**
   d. **Credit it to general reserve**

2. **Government grants that are receivable as compensation for expenses or losses incurred in a previous accounting period or for the purpose of giving immediate financial support to the enterprise with no further related costs, should be**
   a. **recognised and disclosed in the Statement of Profit and Loss of the period in which they are receivable as an ordinary item.**
   b. **recognised and disclosed in the Statement of Profit and Loss of the period in which the losses or expenses were incurred.**
   c. **recognised and disclosed in the Statement of Profit and Loss of the period in which they are receivable, as an extraordinary item if appropriate as per AS 5.**
   d. **disclosed in the Statement of Profit and Loss of the period in which they are receivable, as an extraordinary item**

3. **Which of the following is an acceptable method of accounting presentation for a government grant relating to an asset?**
   a. **Credit the grant immediately to Income statement**
   b. **Show the grant as part of Capital Reserve**
   c. **Reduce the grant from the cost of the asset or show it separately as a deferred income on the Liability side of the Balance Sheet.**
   d. **Show the grant as part of general Reserve**

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4. **X Ltd. has received a grant of Rs.20 crore for purchase of a qualified machine costing Rs.80 crore. X Ltd has a policy to recognise the grant as a deduction from the cost of the asset. The expected remaining useful life of the machine is 10 years. Assume that there is no salvage value and the depreciation method is straight-line. The amount of annual depreciation to be charged as an expense in Profit and Loss Statement will be:**
   a. **Rs.10 crore**
   b. **Rs.6 crore**
   c. **Rs.2 crore**
   d. **Rs.8 crore**

5. **X Ltd has received a grant of Rs.20 crore for purchase of a qualified machine costing Rs.80 crore. X Ltd. has a policy to recognise the grant as deferred income. The expected remaining useful life of the machine is 10 years. Assume that there is no salvage value and the depreciation method is straight-line. The amount of other income to be to be recognised in Profit and Loss Statement will be:**
   a. **Rs.10 crore**
   b. **Rs.6 crore**
   c. **Rs.2 crore**
   d. **Rs.8 crore**

SHRESHTA

ANSWERS/SOLUTIONS

MCQs

1.	**a.**	Credit it to capital reserve
2.	**c.**	recognised and disclosed in the Statement of Profit and Loss of the period in which they are receivable, as an extraordinary item if appropriate as per AS 5.
3.	**c.**	Reduce the grant from the cost of the asset or show it separately as a deferred income on the Liability side of the Balance Sheet.
4.	**b.**	Rs.6 crore
5.	**c.**	Rs.2 crore

THEORY QUESTIONS

Q.NO.1. AS 12 deals with recognition and measurement of government grants. Please elaborate the parameters which are required to be met before an entity can recognise government grants in its books?

ANSWER

A government grant is recognised when there is reasonable assurance that:

- the enterprise will comply with the conditions attaching to it; and
- the grant will be received.

Receipt of a grant is not of itself conclusive evidence that the conditions attaching to the grant have been or will be fulfilled.

PRACTICAL QUESTIONS

Q.NO.1. Supriya Ltd. received a grant of Rs.2,500 lakhs during the accounting year 20X1- 20X2 from government for welfare activities to be carried on by the company for its employees. The grant prescribed conditions for its utilisation. However, during the year 20X2-20X3, it was found that the conditions of grants were not complied with and the grant had to be refunded to the government in full. Elucidate the current accounting treatment, with reference to the provisions of AS-12

SOLUTION

As per AS 12 'Accounting for Government Grants', Government grants sometimes become refundable because certain conditions are not fulfilled. A government grant that becomes refundable is treated as an extraordinary item as per AS 5.

The amount refundable in respect of a government grant related to revenue is applied first against any unamortised deferred credit remaining in respect of the grant. To the extent that the amount refundable exceeds any such deferred credit, or where no deferred credit exists, the amount is charged immediately to profit and loss statement.

In the present case, the amount of refund of government grant should be first adjusted against the unamortised deferred income in the books and the excess if any will be debited to profit & loss account of the company as an extraordinary item in the year 20X2-20X3.

SHRESHTA

UNIT 2: ACCOUNTING STANDARD 14:

ACCOUNTING FOR AMALGAMATIONS

LEARNING OUTCOMES

After studying this unit, you will be able to comprehend the –

- Types of amalgamation – merger and purchase;
- Accounting for amalgamation – Pooling of interest method and purchase method;
- Computation of Purchase consideration;
- Amalgamation post balance sheet date;
- Disclosure requirements of AS 14;

2.1 INTRODUCTION

AS 14 (Revised) deals with the accounting to be made in the books of Transferee company in the case of amalgamation and the treatment of any resultant goodwill or reserve.

An amalgamation may be either in the nature of merger or purchase. The standard specifies the conditions to be satisfied by an amalgamation to be considered as amalgamation in nature of merger or purchase.

An amalgamation in nature of merger is accounted for as per pooling of interests method and in nature of purchase is dealt under purchase method.

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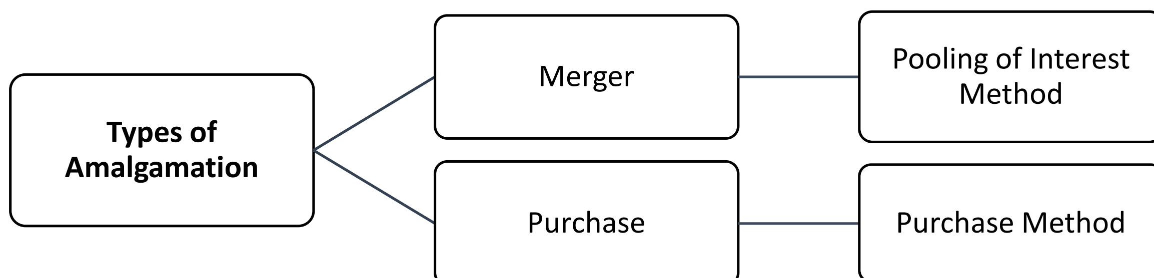


The standard describes the disclosure requirements for both types of amalgamations in the first financial statements. We will discuss the other amalgamation aspects in detail in subsequent paragraphs of this unit.

Note:

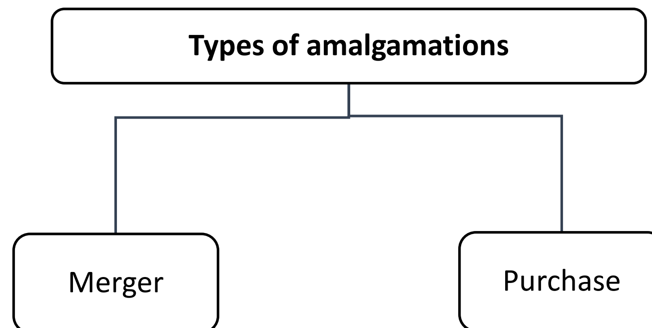
AS 14 (Revised) does not deal with cases of acquisitions. The distinguishing feature of an acquisition is that the acquired company is not dissolved and its separate entity continues to exist.

2.2 DEFINITION OF THE TERMS USED IN THE STANDARD

- Amalgamation means an amalgamation pursuant to the provisions of the Companies Act, 2013 or any other statute which may be applicable to companies and includes 'merger'.
- Transferor company means the company which is amalgamated into another company.
- Transferee company means the company into which a transferor company is amalgamated.

2.3 TYPES OF AMALGAMATIONS

Amalgamations fall into two broad categories.



- **Merger** - In amalgamations where there is a genuine pooling not merely of the assets and liabilities of the amalgamating companies but also of the shareholders' interests and of the businesses of these companies.
- **Purchase** - In amalgamations which are in effect a mode by which one company acquires another company and as a consequence:
- The shareholders of the company which is acquired normally do not continue to have a proportionate share in the equity of the combined company, or
- The business of the company which is acquired is not intended to be continued. Such amalgamations are amalgamations in the nature of 'purchase'.

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2.4 AMALGAMATION IN THE NATURE OF MERGER

Amalgamation in the nature of merger is an amalgamation which satisfies all the following conditions.

i. All the assets and liabilities of the transferor company become, after amalgamation, the assets and liabilities of the transferee company.

ii. Shareholders holding not less than 90% of the face value of the equity shares of the transferor company (other than the equity shares already held therein, immediately before the amalgamation, by the transferee company or its subsidiaries or their nominees) become equity shareholders of the transferee company by virtue of the amalgamation.

iii. The consideration for the amalgamation receivable by those equity shareholders of the transferor company who agree to become equity shareholders of the transferee company is discharged by the transferee company wholly by the issue of equity shares in the transferee company, except that cash may be paid in respect of any fractional shares.

iv. The business of the transferor company is intended to be carried on, after the amalgamation, by the transferee company.

v. No adjustment is intended to be made to the book values of the assets and liabilities of the transferor company when they are incorporated in the financial statements of the transferee company except to ensure uniformity of accounting policies.

Example: X Ltd and Y Ltd are both in telecom business. As per the arrangement X Ltd will get merged with Y Ltd and their shareholders will get shares in Y Ltd. X Ltd operations will going to be continued under Y ltd.

2.5 AMALGAMATION IN THE NATURE OF PURCHASE

Amalgamation in the nature of purchase is an amalgamation which does not satisfy any one or more of the conditions specified above for "Amalgamation in the nature of merger".

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2.6 METHODS OF ACCOUNTING FOR AMALGAMATIONS

There are two main methods of accounting for amalgamations.

- For an amalgamation in the nature of merger - pooling of interests method and
- For an amalgamation in the nature of purchase - purchase method.

2.6.1 Pooling of Interests Method

Pooling of interests is a method of accounting for amalgamations the object of which is to account for the amalgamation as if the separate businesses of the amalgamating companies were intended to be continued by the transferee company. Accordingly, only minimal changes are made in aggregating the individual financial statements of the amalgamating companies.

Under this method, the assets, liabilities and reserves of the transferor company are recorded by the transferee company at their existing carrying amounts

If, at the time of the amalgamation, the transferor and the transferee companies have conflicting accounting policies, a uniform set of accounting policies is adopted following the amalgamation. The effects on the financial statements of any changes in accounting policies are reported in accordance with AS 5.

2.6.2 Purchase Method

Under the purchase method, the transferee company accounts for the amalgamation either

- By incorporating the assets and liabilities at their existing carrying amounts or
- By allocating the consideration to individual identifiable assets and liabilities of the transferor company on the basis of their fair values at the date of amalgamation. The identifiable assets and liabilities may include assets and liabilities not recorded in the financial statements of the transferor company.

2.7 CONSIDERATION

Consideration for the amalgamation means the aggregate of the shares and other securities issued and the payment made in the form of cash or other assets by the transferee company to the shareholders of the transferor company. In determining the value of the consideration, an assessment is made of the fair value of its elements.

Clarification Chart:

Method I – Net Payment Method	**Method II – Net Assets Method**
Note: We need to compute P.C. by Net Payment Method only. If it cannot be computed by Net Payment Method – then Net Assets Method will be applicable.	
Situation I – If it is a Merger	**Situation I – if it is a Merger**
Equity shares issued to ESH (cash may be paid in case fraction arises) + Any form of payment given to PSH	Assets at Book value - Liabilities at Book value - Reserves and Surplus = ESC + PSC
Situation II – If it is a case of Purchase	**Situation II – If it is a case of Purchase**
Any form of payment given to ESH + Any form of payment given to PSH	Assets at agreed value - Liabilities at agreed value

Many amalgamations recognise that adjustments may have to be made to the consideration in the light of one or more future events. When the additional payment is probable and can reasonably be estimated at the date of amalgamation, it is included in the calculation of the consideration. In all other cases, the adjustment is recognised as soon as the amount is determinable

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2.8 TREATMENT OF RESERVES OF THE TRANSFEROR COMPANY ON AMALGAMATION

If the amalgamation is an 'amalgamation in the nature of merger', the identity of the reserves is preserved and they appear in the financial statements of the transferee company in the same form in which they appeared in the financial statements of the transferor company.

Thus, for example, the General Reserve of the transferor company becomes the General Reserve of the transferee company, the Capital Reserve of the transferor company becomes the Capital Reserve of the transferee company and the Revaluation Reserve of the transferor company becomes the Revaluation Reserve of the transferee company. As a result of preserving the identity, reserves which are available for distribution as dividend before the amalgamation would also be available for distribution as dividend after the amalgamation.

2.9 ADJUSTMENTS TO RESERVES - AMALGAMATION IN THE NATURE OF MERGER

When an amalgamation is accounted for using the pooling of interests method, the reserves of the transferee company are adjusted to give effect to the following:

- A uniform set of accounting policies should be adopted following the amalgamation and, hence, the policies of the transferor and the transferee are aligned.
- Difference between the amount recorded as share capital issued (plus any additional consideration in the form of cash or other assets) and the amount of share capital of the transferor company.

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2.10 ADJUSTMENTS TO RESERVES - AMALGAMATION IN THE NATURE OF PURCHASE

If the amalgamation is an 'amalgamation in the nature of purchase', the identity of the reserves, other than the statutory reserves is not preserved. The amount of the consideration is deducted from the value of the net assets of the transferor company acquired by the transferee company. If the result of the computation is negative, the difference is debited to goodwill arising on amalgamation and if the result of the computation is positive, the difference is credited to Capital Reserve.

Certain reserves may have been created by the transferor company pursuant to the requirements of, or to avail of the benefits under, the Income-tax Act, 1961; for example, Development Allowance Reserve, or Investment Allowance Reserve or any other statutory reserve. The Act requires that the identity of the reserves should be preserved for a specified period. Likewise, certain other reserves may have been created in the financial statements of the transferor company in terms of the requirements of other statutes. Though normally, in an amalgamation in the nature of purchase, the identity of reserves is not preserved, an exception is made in respect of reserves of the aforesaid

nature (referred to hereinafter as 'statutory reserves') and such reserves retain their identity in the financial statements of the transferee company in the same form in which they appeared in the financial statements of the transferor company, so long as their identity is required to be maintained to comply with the relevant statute. This exception is made only in those amalgamations where the requirements of the relevant statute for recording the statutory reserves in the books of the transferee company are complied with.

In such cases the statutory reserves are recorded in the financial statements of the transferee company by a corresponding debit to a suitable account head (e.g., 'Amalgamation Adjustment Reserve') which is presented as a separate line item. When the identity of the statutory reserves is no longer required to be maintained, both the reserves and the aforesaid account are reversed.

The Standard gives a title, which reads as "**Reserve**". This gives rise to following requirements.

1. The corresponding debit is "also" to a Reserve Account
2. That Reserve account will show a negative balance
3. But it has to be shown as a separate line item - Which implies, that this debit "cannot be set off against Statutory reserve taken over".

So the presentation will be as follows:

Notes to Accounts for "**Reserves and Surplus**"

Description	**Amount (Current year)**	**Amount (Previous Year)**
Statutory Reserve (taken over from transferor company) General Reserve Profit and Loss or Retained Earnings Amalgamation Adjustment Reserve (negative balance)	(--)	(--)

2.11 TREATMENT OF GOODWILL ARISING ON AMALGAMATION

Goodwill arising on amalgamation represents a payment made in anticipation of future income and it is appropriate to treat it as an asset to be **amortised to income on a systematic basis over its useful life.** Due to the nature of goodwill, it is frequently difficult to estimate its useful life with reasonable certainty. Such estimation is, therefore, made on a prudent basis. Accordingly, it is considered appropriate to amortise goodwill over a period not exceeding five years unless a somewhat longer period can be justified.

Factors which may be considered in estimating the useful life of goodwill arising on amalgamation include:

a. the foreseeable life of the business or industry

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b. the effects of product obsolescence, changes in demand and other economic factors

c. the service life expectancies of key individuals or groups of employees

d. expected actions by competitors or potential competitors

e. legal, regulatory or contractual provisions affecting the useful life

2.12 BALANCE OF PROFIT AND LOSS ACCOUNT

In the case of an ‘amalgamation in the nature of merger’, the balance of the Profit and Loss Account appearing in the financial statements of the transferor company is aggregated with the corresponding balance appearing in the financial statements of the transferee company. Alternatively, it is transferred to the General Reserve, if any.

In the case of an ‘amalgamation in the nature of purchase’, the balance of the Profit and Loss Account appearing in the financial statements of the transferor company, whether debit or credit, loses its identity.

2.13 DISCLOSURES

For all amalgamations, the following disclosures are considered appropriate in the first financial statements following the amalgamation:

a. Names and general nature of business of the amalgamating companies;

b. Effective date of amalgamation for accounting purposes;

c. The method of accounting used to reflect the amalgamation; and

d. Particulars of the scheme sanctioned under a statute.

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For amalgamations accounted for under the pooling of interests method, the following additional disclosures are considered appropriate in the first financial statements following the amalgamation:

a. Description and number of shares issued, together with the percentage of each company’s equity shares exchanged to effect the amalgamation;

b. The amount of any difference between the consideration and the value of net identifiable assets acquired, and the treatment thereof.

For amalgamations accounted for under the purchase method, the following additional disclosures are considered appropriate in the first financial statements following the amalgamation:

a. Consideration for the amalgamation and a description of the consideration paid or contingently payable; and

b. The amount of any difference between the consideration and the value of net identifiable assets acquired, and the treatment thereof including the period of amortisation of any goodwill arising on amalgamation.

2.14 AMALGAMATION AFTER THE BALANCE SHEET DATE

When an amalgamation is effected after the balance sheet date but before the issuance of the financial statements of either party to the amalgamation **disclosure is made in accordance with AS 4 'Contingencies and Events Occurring After the Balance Sheet Date'** but the amalgamation is not incorporated in the financial statements. In certain circumstances the amalgamation may also provide additional information affecting the financial statements themselves for instance by **allowing the going concern assumption to be maintained**.

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ILLUSTRATIONS

Illustration 1

i. **A Ltd. take over B Ltd. on April 01, 20X1 and discharges consideration for the business as follows: Issued 42,000 fully paid equity shares of Rs.10 each at par to the equity shareholders of B Ltd.**

ii. **Issued fully paid up 15% preference shares of Rs.100 each to discharge the preference shareholders (Rs.1,70,000) of B Ltd. at a premium of 10%.**

iii. **It is agreed that the debentures of B Ltd. (Rs.50,000) will be converted into equal number and amount of 13% debentures of A Ltd.**

Determine the amount of purchase consideration as per AS 14

Solution

Particulars	Rs.
Equity Shares (42,000 x 10)	4,20,000
15% Preference Share Capital	1,70,000
Add: Premium on Redemption	17,000
Purchase Consideration	6,07,000

Note: As per AS 14, consideration for the amalgamation means the aggregate of the shares and other securities issued and the payment made in the form of cash or other assets by the transferee company to the shareholders of the transferor company. Thus, payment to debenture holders are not covered by the term 'consideration'.

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Illustration 2

A Ltd. and B Ltd. were amalgamated on and from 1st April, 20X1. A new company C Ltd. was formed to take over the business of the existing companies. A Ltd. and B Ltd. have the following ledger balances as on 31st March, 20X1:

	A Ltd. (Rs.in lakhs)	B Ltd. (Rs.in lakhs)
Land and Building	**550**	**400**
Plant and Machinery	**350**	**250**
Investments (Non-current)	**150**	**50**
Inventory	**350**	**250**
Trade Receivables	**300**	**350**
Cash and Bank	**300**	**200**

Share Capital:		
Equity Shares of Rs.100 each	**800**	**750**
12% Preference shares of Rs.100 each	**300**	**200**
Reserves and Surplus:		
Revaluation Reserve	**150**	**100**
General Reserve	**170**	**150**
Investment Allowance Reserve	**50**	**50**
Profit and Loss Account	**50**	**30**
Secured Loans:		
10% Debentures (Rs.100 each)	**60**	**30**
Trade Payables	**420**	**190**

Additional Information:

1. **10% Debenture holders of A Ltd. and B Ltd. are discharged by C Ltd. issuing such number of its 15% Debentures of Rs.100 each so as to maintain the same amount of interest.**
2. **Preference shareholders of the two companies are issued equivalent number of 15% preference shares of C Ltd. at a price of Rs.150 per share (face value of Rs.100).**
3. **C Ltd. will issue 5 equity shares for each equity share of A Ltd. and 4 equity shares for each equity share of B Ltd. The shares are to be issued @ Rs.30 each, having a face value of Rs.10 per share.**
4. **Investment allowance reserve is to be maintained for 4 more years. Prepare the Balance Sheet of C Ltd. as on 1st April, 20X1 after the amalgamation has been carried out on the basis of Amalgamation in the nature of purchase.**

Solution

Balance Sheet of C Ltd. as at 1st April, 20X1

Particulars	**Note No.**	**(Rs.in lakhs)**
i. Equity and Liabilities		
1. Shareholder's Funds		
a. Share Capital	1	1,200
b. Reserves and Surplus	2	1,650
2. Reserves and Surplus Non-Current Liabilities		
Long-term borrowings	3	60
3. Current Liabilities		
Trade payables	8	610
Total		3,520

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ii. Assets		
1. Non-current assets		
a. Property, Plant and Equipment	4	1,550
b. Intangible assets	5	20
c. Non-current investments	6	200
2. Current assets		
a. Inventory (350 + 250)		600
b. Trade receivables	7	650
c. Cash and bank balances (300 + 200)		500
Total		3,520

Notes to Accounts

		(Rs.in lakhs)	(Rs.in lakhs)
1.	Share Capital		
	Equity share capital (W.N.1)		
	70,00,000[1] Equity shares of Rs.10 each	700	
	5,00,000[2] Preference shares of Rs.100 each	500	
	(all the above shares are allotted as fully paid-up pursuant to contracts without payment being received in cash)		1,200
2.	Reserves and surplus		
	Securities Premium Account (W.N.3) (950 + 700)	1,650	
	Investment Allowance Reserve (50 + 50) Amalgamation	100	
	Adjustment Reserve (50 + 50)	(100)	1,650
3.	Long-term borrowings		
	15% Debentures		60
4.	Property, Plant and Equipment		
	Land and Building (550 + 400)	950	
	Plant and Machinery (350 + 250)	600	
5.	Intangible assets		1,550
	Goodwill [W.N. 2] (110 – 90)		20
6.	Non-current Investments		
	Investments (150 + 50)		200
7.	Trade receivables (300 + 350)		650
8.	Trade payables (420 + 190)		610

[1] 40,00,000 + 30,00,000

[2] 3,00,000 + 2,00,000

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Working Notes:

		(Rs.in lakhs)	
		A Ltd.	B Ltd.
1.	Computation of Purchase consideration		
	a. Preference shareholders:		
	$\left(\frac{3,00,00,000}{100} \text{ i.e. } 3,00,000 \text{ shares}\right) \times \text{Rs.150 each}$	450	
	$\left(\frac{2,00,00,000}{100} \text{ i.e. } 2,00,000 \text{ shares}\right) \times \text{Rs.150 each}$		300
	b. Equity shareholders:		
	$\left(\frac{8,00,00,000 \times 5}{100} \text{ i.e. } 40,00,000 \text{ shares}\right) \times \text{Rs.30 each}$	1,200	
	$\left(\frac{7,50,00,000 \times 4}{100} \text{ i.e. } 30,00,000 \text{ shares}\right) \times \text{Rs.30 each}$		900
	Amount of Purchase Consideration	1,650	1,200
2.	Net Assets Taken Over		
	Assets taken over:		
	Land and Building	550	400
	Plant and Machinery	350	250
	Investments	150	50
	Inventory	350	250
	Trade receivables	300	350
	Cash at bank	300	200
		2,000	1,500
	Less:		
	Liabilities taken over:		
	Debentures 40		20
	Trade payables 420		190
		460	210
	Net assets taken over	1,540	1,290
	Purchase consideration	1,650	1,200
	Goodwill	110	-
	Capital reserve		90
3.	Computation of securities premium		

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	On preference share capital		
	A Ltd.- 3,00,000 x 50	150	
	B Ltd.- 2,00,000 x 50		100
	On equity share capital		
	A Ltd.- 40,00,000 x 20	800	
	B Ltd.- 30,00,000 x 20	___	600
	Total	950	700

Note: For problems based on practical application of AS 14 (Revised) students are advised to refer Chapter 14 ‘Accounting for Amalgamation of Companies’ of the study material.

SHRESHTA

TEST YOUR KNOWLEDGE

MCQs

1. **Which of the following statement is correct:**
   a. **In case of merger – ESH can be issued only equity shares as a part of Purchase consideration.**
   b. **In case of purchase – ESH can be issued Preference shares also as a part of Purchase consideration.**
   c. **Both a. and b. are correct.**
   d. **Both a. and b. are incorrect.**

2. **State which statement is correct:**
   a. **In case of merger – assets and liabilities can only be taken over at book values.**
   b. **In case of purchase – assets and liabilities can be taken over at book values or agreed values.**
   c. **Both a. and b. are correct.**
   d. **Both a. and b. are incorrect.**

3. **State which statement is correct:**
   a. **In case of merger – All Reserves and surplus of vendor company are taken over by Purchasing company.**
   b. **In case of Purchase – None of the Reserves and surplus of vendor company are taken over by Purchasing company.**
   c. **Both a. and b. are correct.**
   d. **Only a. is correct.**

4. **State which statement is correct:**
   a. **In case of merger – We use pooling of interest method for accounting.**
   b. **In case of Purchase, we use purchase method or pooling of interest method depending upon whether it is take over at agreed values or book values.**
   c. **Both a. and b. are correct.**
   d. **Only a. is correct**

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5. **State which statement is incorrect:**
   a. **In case of merger – We can issue either preference shares or equity shares to PSH.**
   b. **In case of Purchase – We can issue either preference shares or equity shares to PSH.**
   c. **In case of merger – We can issue only preference shares to PSH.**
   d. **none of the above.**

ANSWERS/SOLUTIONS

MCQs

1.	**b.**	In case of purchase – ESH can be issued Preference shares also as a part of Purchase consideration.
2.	**c.**	Both a. and b. are correct.
3.	**d.**	Only a. is correct.
4.	**d.**	Only a. is correct
5.	**c.**	In case of merger – We can issue only preference shares to PSH.

THEORY QUESTIONS

Q.NO.1. Briefly describe the disclosure requirements for amalgamation including additional disclosure, if any, for different methods of amalgamation as per AS 14 (Revised).

ANSWER

The disclosure requirements for amalgamations have been prescribed in paragraphs 43 to 46 of AS 14 (Revised) on Accounting for Amalgamation. Refer Para 2.5 for details.

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Q.NO.2. List the conditions to be fulfilled as per AS 14 (Revised) for an amalgamation to be in the nature of merger, in the case of companies.

ANSWER

According to AS 14 "Accounting for Amalgamations", Amalgamation in the nature of merger is an amalgamation which satisfies all the following conditions:

i. All the assets and liabilities of the transferor company become, after amalgamation, the assets and liabilities of the transferee company.

ii. Shareholders holding not less than 90% of the face value of the equity shares of the transferor company (other than the equity shares already held therein, immediately before the amalgamation, by the transferee company or its subsidiaries or their nominees) become equity shareholders of the transferee company by virtue of the amalgamation.

iii. The consideration for the amalgamation receivable by those equity shareholders of the transferor company who agree to become equity shareholders of the transferee company is discharged by the transferee company wholly by the issue of equity shares in the transferee company, except that cash may be paid in respect of any fractional shares.

iv. The business of the transferor company is intended to be carried on, after the amalgamation, by the transferee company.

v. No adjustment is intended to be made to the book values of the assets and liabilities of the transferor company when they are incorporated in the financial statements of the transferee company except to ensure uniformity of accounting policies.

Q.NO.3. Briefly explain the methods of accounting for amalgamation as per Accounting Standard-14.

ANSWER

As per AS 14 on 'Accounting for Amalgamations', there are two main methods of accounting for amalgamations:

The Pooling of Interest Method

Under this method, the assets, liabilities and reserves of the transferor company are recorded by the transferee company at their existing carrying amounts (after making the necessary adjustments).
If at the time of amalgamation, the transferor and the transferee companies have conflicting accounting policies, a uniform set of accounting policies is adopted following the amalgamation. The effects on the financial statements of any changes in accounting policies are reported in accordance with AS 5 on 'Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies'.

The Purchase Method

Under the purchase method, the transferee company accounts for the amalgamation either by incorporating the assets and liabilities at their existing carrying amounts or by allocating the consideration to individual identifiable assets and liabilities of the transferor company on the basis of their fair values at the date of amalgamation. The identifiable assets and liabilities may include assets and liabilities not recorded in the financial statements of the transferor company.

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PRACTICAL PROBLEMS

Q.NO.1. X Co. Ltd. having share capital of Rs.50 lakhs divided into equity shares of Rs.10 each was taken over by Y Co. Ltd. Y Co. Ltd. issued 11 equity shares of Rs.10 each for every 10 shares of X Co. Ltd. Explain how the difference will be adjusted in the books of Y Co. Ltd. for the shares issued under the 'Pooling of interests method' of amalgamation as per AS 14.

SOLUTION

Particulars	Rs.
Purchase consideration = 5,00,000 x 11/10 = 55,000 shares of Rs.10 each	55,00,000
Less: Share capital of X Co. Ltd.	50,00,000
Difference Adjusted through General Reserve	5,00,000

On 1st April, 2018, Tina Ltd. take over the business of Rina Ltd. and discharged purchase consideration as follows:

i. **Issued 50,000 fully paid Equity shares of Rs.10 each at a premium of Rs.5 per share to the equity shareholders of Rina Ltd.**
ii. **Cash payment of Rs.50,000 was made to equity shareholders of Rina Ltd.**
iii. **Issued 2,000 fully paid 12% Preference shares of Rs.100 each at par to discharge the preference shareholders of Rina Ltd.**
iv. **Debentures of Rina Ltd. 20,000) will he converted into equal number and amount of 10% debentures of Tina Ltd.**

Calculate the amount of Purchase consideration as per AS-14 and pass Journal Entry relating to discharge of purchase consideration in the books of Tina Ltd.

SOLUTION

As per AS 14, consideration for the amalgamation means the aggregate of the shares and other securities issued and the payment made in the form of cash or other assets by the transferee company to the shareholders of the transferor company.

Computation of Purchase Consideration

Particulars	Rs.
Equity Shares (50,000x 15)	7,50,000
Cash payment	50,000
12% Preference Share Capital	2,00,000
Purchase Consideration	10,00,000

Note: Payment to debenture holders is not covered by the term 'consideration'.

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Journal entry

Particulars		Rs.
Liquidation of Rina Ltd. A/c	10,00,000	
To Equity share capital A/c		5,00,000
To 12% Preference share capital A/c		2,00,000
To Securities premium A/c		2,50,000
To Bank/Cash A/c		50,000
(Being payment of cash and issue of shares for discharge of purchase consideration)		

SHRESHTA

10. ACCOUNTING STANDARDS FOR CONSOLIDATED FINANCIAL STATEMENTS

UNIT 1 ACCOUNTING STANDARD 21: CONSOLIDATED FINANCIAL STATEMENTS

LEARNING OUTCOMES

After studying this chapter, you will be able to:

- Understand the concepts of Group, holding company and subsidiary company.
- Apply the consolidation procedures for consolidation of financial statements of subsidiaries with the holding companies.
- Prepare the consolidated financial statements and solve related problems

Note: As per the syllabus, the unit covers simple problems on consolidated financial statements with single subsidiary and excludes problems involving acquisition of Interest in Subsidiary at Different Dates, Cross holding, Disposal of a Subsidiary and Foreign Subsidiaries.

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1.1 CONCEPT OF GROUP, HOLDING COMPANY AND SUBSIDIARY COMPANY

In an era of business growth, many organizations are growing into large corporations by the process of acquisition, mergers, gaining control by one company over the other company, restructuring etc. Acquisitions and mergers ultimately lead to either cost reduction or controlling the market or sharing the material supplies or product diversification or availing tax benefits or synergy. Whatever the motto behind these ventures is, the ultimate result is the large-scale corporation. Formation of holding company is the most popular device for achieving these objectives.

Group of Companies

Many a time, a company expands by keeping intact its separate corporate identity. In this situation, a company (i.e. holding company) gains control over the other company (subsidiary company). This control is exercised by one company over the other by

1. Purchasing specified number of shares i.e. ownership through voting power of that company or
2. Exercising control over the board of directors.

The companies connected in these ways are collectively called as a **Group of Companies**.

Holding Company and Subsidiary Company have also been defined in Section 2 of the Companies Act, 2013.

Holding company

As per Section 2(46) of the Companies Act, 2013,

"Holding company", in relation to one or more other companies, means a company of which such companies are subsidiary companies.

It may be defined as one, which has one or more subsidiary companies and enjoys control over them. Legally a holding company and its subsidiaries are distinct and separate entities. However, in substance holding and subsidiary companies work as a group. Accordingly, users of holding company's accounts need financial information of subsidiaries also to understand the performance and financial position of the group (i.e. holding company and subsidiaries on a consolidated basis).

Subsidiary Company

Section 2(87) of the Companies Act, 2013 defines "subsidiary company" as a company in which the holding company –

i. controls the composition of the Board of Directors; or

ii. exercises or controls more than one-half of the total share capital either at its own or together with one or more of its subsidiary companies:

A company shall be deemed to be a subsidiary company of the holding company even if there is indirect control through the subsidiary company (ies).

The control over the composition of a subsidiary company's Board of Directors means exercise of power to appoint or remove all or a majority of the directors of the subsidiary company.

Section 19 of the Companies Act, 2013 prohibits a subsidiary company from holding shares in the holding company. According to this section, no company shall, either by itself or through its nominees, hold any shares in its holding company and no holding company shall allot or transfer its shares to any of its subsidiary companies and any such allotment or transfer of shares of a company to its subsidiary company shall be void.

However, a subsidiary may continue to be a member of its holding company when

a. the subsidiary company holds such shares as the legal representative of a deceased member of the holding company; or

b. the subsidiary company holds such shares as a trustee; or

c. the subsidiary company is a shareholder even before it became a subsidiary company of the holding company.

The subsidiary company shall have a right to vote at a meeting of the holding company only in respect of the shares held by it as a legal representative or as a trustee, as mentioned above in point (a) and (b).

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Applicable Accounting Standard

Accounting Standard (AS) 21: Consolidated Financial Statements provides guidance on preparation of Consolidated Financial Statements, the purpose of which is discussed in Para 3 below.

This Standard came into effect in respect of accounting periods commenced on or after 1-4-2001. AS 21 lays down principles and procedures for preparation and presentation of consolidated financial statements. Consolidated financial statements are presented by the parent (holding company) to provide financial information about the economic activities of the group as a single economic entity. The parent presenting consolidated financial statements should present such statements in accordance with this standard but in its separate financial statements, investments in subsidiaries would be accounted as per AS 13.

1.2 OBJECTIVES OF AS 21

The objective of this Standard is to lay down principles and procedures for preparation and presentation of consolidated financial statements. Consolidated Financial Statements are prepared by the holding/parent company to provide financial information regarding the economic resources controlled by its group and results achieved with these resources. These consolidated financial statements are prepared by the parent company in addition to the financial statement prepared by the parent company for only its own affairs. Hence parent company prepares two financial statements, one for only its own affairs and one for taking the whole group as one unit in the form of consolidated financial statements. Consolidated financial statements usually comprise the following:

- Consolidated Balance Sheet
- Consolidated Profit & Loss Statement
- Notes to Accounts, other statements and explanatory material
- Consolidated Cash Flow Statement, if parent company presents its own cash flow statement.

While preparing the consolidated financial statement, all other ASs and Accounting Policies will be applicable as they are applied in parent company's own financial statements.

A parent which presents consolidated financial statements should consolidate all subsidiaries, domestic as well as foreign. Where an enterprise does not have a subsidiary but has an associate and/or a joint venture such an enterprise should also prepare consolidated financial statements in accordance with Accounting Standard (AS) 23, Accounting for Associates in Consolidated Financial Statements, and Accounting Standard (AS) 27, Financial Reporting of Interests in Joint Ventures respectively.

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Definitions as per Accounting Standard (AS) 21

Parent:

A parent is an enterprise that has one or more subsidiaries.

Subsidiary is an enterprise that is controlled by another enterprise (known as the parent).

Control:

a. the ownership, directly or indirectly through subsidiary(ies), of more than one-half of the voting power of an enterprise; or

b. control of the composition of the board of directors in the case of a company or of the composition of the corresponding governing body in case of any other enterprise so as to obtain economic benefits from its activities.

Group:

A group is a parent and all its subsidiaries.

Minority interest is that part of the net results of operations and of the net assets of a subsidiary attributable to interests which are not owned, directly or indirectly through subsidiary(ies), by the parent.

Equity is the residual interest in the assets of an enterprise after deducting all its liabilities.

Consolidated financial statements are the financial statements of a group presented as those of a single enterprise.

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Circumstances under which Consolidated Financial Statements are prepared

AS 21 should be applied in the preparation and presentation of consolidated financial statements for a group of enterprises under the control of a parent.

Consolidated financial statements are the financial statements of a group presented as those of a single enterprise.

AS 21 does not mandate which enterprises are required to prepare consolidated financial statements – but specifies the rules to be followed where such financial statements are prepared.

Consolidated Financial Statements will be prepared by the parent company for all the companies that are controlled by the parent company either directly or indirectly, situated in India or abroad except in certain cases.

1.3 WHOLLY OWNED AND PARTLY OWNED SUBSIDIARIES

S. No.	Wholly owned subsidiary company	Partly owned subsidiary company
1.	A wholly owned subsidiary company is one in which all the shares are owned by the holding company.	In a partly owned subsidiary, all the shares of subsidiary company are not acquired by the holding company i.e. only the majority

		of shares (i.e., more than 50%) are owned by the holding company.
2.	100% voting rights are vested by the holding company.	Voting rights of more than 50% but less than 100% are vested by the holding company.
3.	There is no minority interest because all the shares with voting rights are held by the holding company.	There is a minority interest because less than 50% shares with voting rights are held by outsiders other than the holding company.

1.4 PURPOSE OF PREPARING THE CONSOLIDATED FINANCIAL STATEMENTS

Consolidated financial statements (CFS) are the financial statements of a 'group' presented as those of a single enterprise, where a 'group' refers to a parent and all its subsidiaries. Parent company needs to inform the users about the financial position and results of operations of not only of their enterprise itself but also of the group as a whole. For this purpose, consolidated financial statements are prepared and presented by a parent/holding enterprise to provide financial information about a parent and its subsidiary(ies) as a single economic entity.

CFS are intended to show the financial position of the group as a whole - by showing the economic resources controlled by them, by presenting the obligations of the group and the results the group achieves with its resources.

CFS normally include consolidated balance sheet, consolidated statement of profit and loss, and notes, other statements and explanatory material that form an integral part thereof. Consolidated cash flow statement is presented in case a parent presents its own cash flow statement. The consolidated financial statements are presented, to the extent possible, in the same format as that adopted by the parent for its separate financial statements.

The logic for presentation of Consolidated Financial Statements can be appreciated with the help of an example below:

Assume that you are holding 10 shares of Reliance Industries Limited, one of the largest conglomerates in India. If you look at Reliance Industries Limited's separate (standalone) balance sheet, you can see investments in subsidiaries like Jio Platforms Limited, Reliance Jio Infocom Limited, Reliance Retail Limited etc. Now, if we see the standalone financials of Reliance Industries Limited, the revenue is generated from Oil & Gas Business. However, we all know that equally significant for Reliance Industries Limited is the revenue generated from its subsidiary companies.

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Further, being a holding company, all operational decisions of the subsidiary companies are taken by Reliance Industries Limited. In other words, though the holding company and its subsidiaries are legally different entities, in substance, all the operations of the subsidiaries are merely an extension of the holding company, and the assets and liabilities of the subsidiaries are controlled by the holding company.

Technically, Investments appearing in the balance sheet of Reliance Industries Limited represents proportionate share in the net worth of the respective subsidiary as well as is also a proportionate share in the profits earned by such subsidiaries. Accordingly, consolidating the incomes and expenses, as well as the assets and liabilities of the subsidiary companies with that of the parent company will result in a better presentation of the operations as well as the financial position of Reliance Industries Limited.

Relevant provisions of the Companies Act 2013

Where a company has one or more subsidiaries or associate companies, it shall, in addition to the standalone financial statements, prepare a consolidated financial statement of the company and of all the subsidiaries and associate companies in the same form and manner as that of its own and in accordance with applicable accounting standards, which shall also be laid before the annual general meeting (AGM) of the company along with the laying of its financial statement.

The company shall also attach along with its financial statement, a separate statement containing the salient features of the financial statement of its subsidiary or subsidiaries in Form AOC-1 as per Rule 5 of the Companies (Accounts) Rules, 2014.

For the purpose of section 129, 'subsidiary' includes 'associate company' and 'joint venture' which means that the company would be required to prepare consolidated financial statements including associate/ joint venture even if there is no subsidiary of a company.

The consolidation of financial statements of the company shall be made in accordance with the provisions of Schedule III of the Companies Act 2013 and the applicable accounting standards.

In case of a company covered under sub-section (3) of section 129 which is not required to prepare consolidated financial statements under the Accounting Standards, it shall be sufficient if the company complies with provisions of consolidated financial statements provided in Schedule III of the Act.

Knowledge Pulse ? – Did you know why we have to prepare consolidation in the above case? What is the logic behind consolidation? Why can't we just prepare normal standalone FS? –

Not an exam question but to understand the logic, we will see you in the class

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Exemptions from preparation of CFS: As per Companies (Accounts) Amendment Rules, 2016, preparation of consolidated financial statements by a company is not required if it meets the following conditions:

i. it is a wholly-owned subsidiary, or is a partially-owned subsidiary of another company and all its other members, including those not otherwise entitled to vote, having been intimated in writing and for which the proof of delivery of such intimation is available with the company, do not object to the company not presenting consolidated financial statements (S.129 of companies act giving exemption);

ii. it is a company whose securities are not listed or are not in the process of listing on any stock exchange, whether in or outside India; (i.e., Unlisted Companies) and

iii. its ultimate or any intermediate holding company files consolidated financial statements with the Registrar which are in compliance with the applicable Accounting Standards (i.e., The company is not ultimate holding).

AS 21 also lays down the accounting principles and procedures for preparation and presentation of consolidated financial statements which have been covered in the later part of this chapter.

It may be pertinent to note that in certain countries outside India, presentation of standalone financial statements is not mandatory. In fact, it is the preparation and presentation of consolidated financial statements that are mandatory, given the reasoning behind Consolidated Financial Statements already discussed in the example of Reliance Industries Limited above.

In India, the statutory framework (such as the Companies Act, 2013 or the Income Tax Act, 1961) mandate presentation of standalone financial statements, thereby making standalone financial statements equally important as consolidated financial statements.

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1.5 SCOPE OF AS 21

1. This Standard should be applied in the preparation and presentation of consolidated financial statements for a group of enterprises under the control of a parent.
2. This Standard should also be applied in accounting for investments in subsidiaries in the separate financial statements of a parent.
3. In the preparation of consolidated financial statements, other Accounting Standards also apply in the same manner as they apply to the separate statements.
4. This Standard does not deal with:
    - **a.** methods of accounting for amalgamations and their effects on consolidation, including goodwill arising on amalgamation (see AS 14, Accounting for Amalgamations);
    - **b.** accounting for investments in associates (governed by AS 13, Accounting for Investments); and

c. accounting for investments in joint ventures (governed by AS 13, Accounting for Investments).

Note: AS 21 is mandatory if an enterprise presents consolidated financial statements. In other words, the accounting standard does not mandate an enterprise to present consolidated financial statements but, if the enterprise presents consolidated financial statements for complying with the requirements of any statute or otherwise, it should prepare and present consolidated financial statements in accordance with AS 21.

1.6 CONTROL

The consolidated financial statements are prepared on the basis of financial statements of parent and all enterprises that are controlled by the parent, other than those subsidiaries excluded for the reasons set out in paragraph 11 of AS 21.

Control exists when the parent owns, directly or indirectly through subsidiary(ies), more than one-half of the voting power of an enterprise. Control also exists when an enterprise controls the composition of the board of directors (in the case of a company) or of the corresponding governing body (in case of an enterprise not being a company) so as to obtain economic benefits from its activities.

An enterprise may control the composition of the governing bodies of entities such as gratuity trust, provident fund trust etc. Since the objective of control over such entities is not to obtain economic benefits from their activities, these are not considered for the purpose of preparation of consolidated financial statements.

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For the purpose of this Standard, an enterprise is considered to control the composition of

i. the board of directors of a company, if it has the power, without the consent or concurrence of any other person, to appoint or remove all or a majority of directors of that company. An enterprise is deemed to have the power to appoint a director, if any of the following conditions is satisfied:

   a. a person cannot be appointed as director without the exercise in his favour by that enterprise of such a power as aforesaid; or

   b. a person's appointment as director follows necessarily from his appointment to a position held by him in that enterprise; or

   c. the director is nominated by that enterprise or a subsidiary thereof.

ii. the governing body of an enterprise that is not a company, if it has the power, without the consent or the concurrence of any other person, to appoint or remove all or a majority of members of the governing body of that other enterprise. An enterprise is deemed to have the power to appoint a member, if any of the following conditions is satisfied:

a. a person cannot be appointed as member of the governing body without the exercise in his favour by that other enterprise of such a power as aforesaid; or
b. a person's appointment as member of the governing body follows necessarily from his appointment to a position held by him in that other enterprise; or
c. the member of the governing body is nominated by that other enterprise.

Note: It is possible that an enterprise is controlled by two enterprises – one controls by virtue of ownership of majority of the voting power of that enterprise and the other controls, by virtue of an agreement or otherwise, the composition of the board of directors so as to obtain economic benefits from its activities. In such a rare situation, when an enterprise is controlled by two enterprises as per the definition of 'control', the first mentioned enterprise will be considered as subsidiary of both the controlling enterprises within the meaning of AS 21 and, therefore, both the enterprises need to consolidate the financial statements of that enterprise.

1.7 EXCLUSION FROM PREPARATION OF CONSOLIDATED FINANCIAL STATEMENTS

As per AS 21, a subsidiary should be excluded from consolidation when:

a. **control is intended to be temporary** because the subsidiary is acquired **and held** exclusively **with a view to its subsequent disposal in the near future; or**
b. it operates under **severe long-term restrictions** which significantly impair its ability to transfer funds to the parent.

In consolidated financial statements, investments in such subsidiaries should be accounted for in accordance with AS 13 'Accounting for Investments'. The reasons for not consolidating a subsidiary should be disclosed in the consolidated financial statements.

Where an enterprise owns majority of voting power by virtue of ownership of the shares of another enterprise and all the shares are held as 'stock-in-trade' and are acquired and held exclusively with a view to their subsequent disposal in the near future, the control by the first mentioned enterprise is considered to be temporary. It would be pertinent to note that merely holding all the shares as 'stock-in-trade', is not sufficient to be considered as temporary control. It is only when all the shares held as 'stock-in-trade' are acquired and held exclusively with a view to their subsequent disposal in the near future, that control would be considered to be temporary within the meaning of point (a) above.

The period of time, which is considered as **"near future"** as mentioned above, primarily depends on the facts and circumstances of each case. However, ordinarily, the meaning of the words **'near future'** is considered as not more than twelve months from acquisition of relevant investments

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unless a longer period can be justified on the basis of facts and circumstances of the case. The intention with regard to disposal of the relevant investment is considered at the time of acquisition of the investment. Accordingly if the relevant investment is acquired without an intention to its subsequent disposal in near future, and subsequently, it is decided to dispose off the investments, such an investment is not excluded from consolidation, until the investment is actually disposed off. Conversely, if the relevant investment is acquired with an intention to its subsequent disposal in near future, but, due to some valid reasons, it could not be disposed off within that period, the same will continue to be excluded from consolidation, provided there is no change in the intention.

Exclusion of a subsidiary from consolidation on the ground that its business activities are dissimilar from those of the other enterprises within the group is not justified because better information is provided by consolidating such subsidiaries and disclosing additional information in the consolidated financial statements about the different business activities of subsidiaries. Extending the above Reliance Industries Limited example, though the parent company is in the Oil and Gas Business, and its subsidiaries operate in industries such as telecom, retail trade, fashion and lifestyle, media etc., all the entities have to be consolidated as such consolidated financial statements will then provide better picture of the business and financial position of Reliance Industries Limited. For example, the disclosures required by AS 17 'Segment Reporting', help to explain the significance of different business activities within the group.

Consolidation of a subsidiary which is a Limited Liability Partnership (LLP) or a Partnership Firm

As per rule 6 of Companies (Accounts) Rules, 2014, under the heading 'Manner of consolidation of accounts' it is provided that consolidation of financial statements of a company shall be done in accordance with the provisions of Schedule III to the Companies Act, 2013 and the applicable Accounting Standards.

It is noted that relevant Indian Accounting Standard i.e., Ind AS 110, Consolidated Financial Statements provides that where an entity has control on one or more other entities, the controlling entity is required to consolidate all the controlled entities. Since, the word 'entity' includes a company as well as any other form of entity, therefore, LLPs and partnership firms are required to be consolidated.

Similarly, under Accounting Standard (AS) 21, as per the definition of subsidiary, an enterprise controlled by the parent is required to be consolidated. The term 'enterprise' includes a company and any enterprise other than a company. Therefore, under AS also, LLPs and partnership firms are required to be consolidated.

Accordingly, in the given case, holding company is required to consolidate its subsidiary which is an LLP or a partnership firm.

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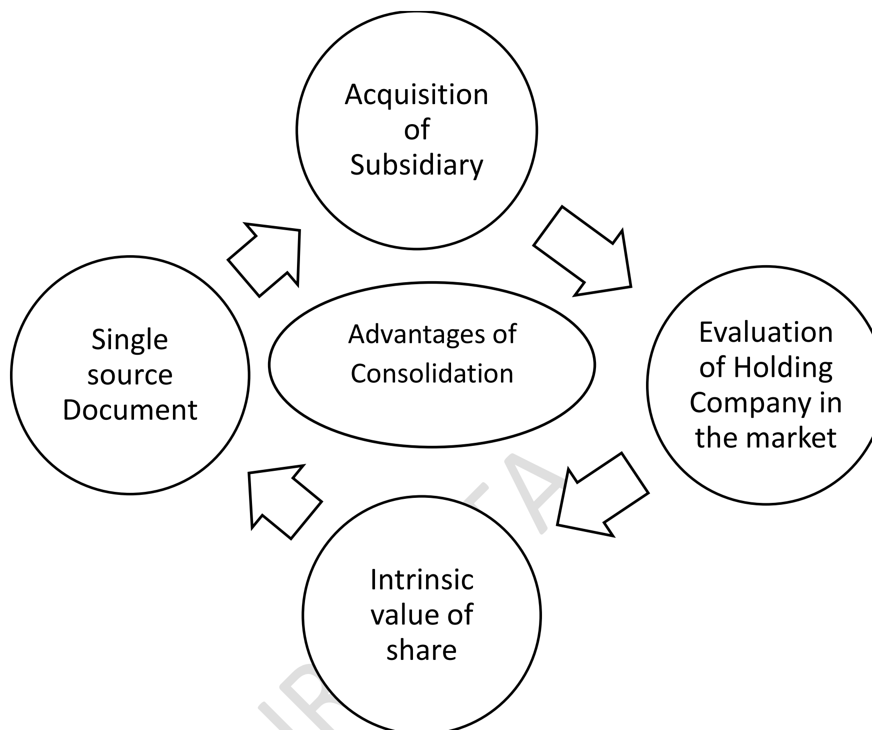
Consolidation of Limited Liability Partnership (LLP) which is an Associate or Joint Venture

If LLP or a partnership firm is an associate or joint venture of holding company, even then the LLP and the partnership firm need to be consolidated in accordance with the requirements of applicable Accounting Standards.

1.8 ADVANTAGES OF CONSOLIDATED FINANCIAL STATEMENTS



The main advantages of consolidation are given below:

i. **Single source document:** From the consolidated financial statements, the users of accounts can get an overall picture of the Group (i.e. holding company and its subsidiaries). Consolidated profit and loss account gives the overall profitability of the group.

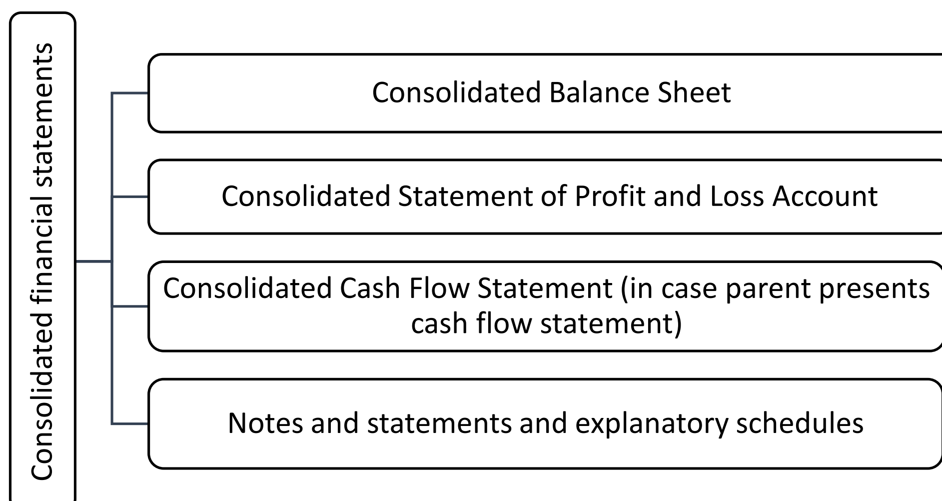
ii. **Intrinsic value of share:** Intrinsic share value of the holding company can be calculated directly from the Consolidated Balance Sheet.

iii. **Acquisition of subsidiary:** The minority interest data of the consolidated financial statement indicates that the amount payable to the outside shareholders of the subsidiary company at book value which is used as the starting point of bargaining at the time of acquisition of a subsidiary by the holding company.

iv. **Evaluation of holding company in the market:** The overall financial health of the holding company can be judged using consolidated financial statements. Those who want to invest in the shares of the holding company or acquire it, need such consolidated statement for evaluation.

1.9 COMPONENTS OF CONSOLIDATED FINANCIAL STATEMENTS

As per AS 21, consolidated financial statements normally include the following:



- The consolidated financial statements are presented to the extent possible in the same format as that adopted by the parent for its separate financial statements.

All the notes appearing in the separate financial statements of the parent enterprise and its subsidiaries need not be included in the notes to the consolidated financial statement. For preparing consolidated financial statements, the following principles may be observed in respect of notes and other explanatory material that form an integral part thereof:

a. Notes which are necessary for presenting a true and fair view of the consolidated financial statements are included in the consolidated financial statements as an integral part thereof.

b. Only the notes involving items which are material need to be disclosed. Materiality for this purpose is assessed in relation to the information contained in consolidated financial statements. In view of this, it is possible that certain notes which are disclosed in separate financial statements of a parent or a subsidiary would not be required to be disclosed in the consolidated financial statements when the test of materiality is applied in the context of consolidated financial statements.

c. Additional statutory information disclosed in separate financial statements of the subsidiary and/or a parent having no bearing on the true and fair view of the consolidated financial statements need not be disclosed in the consolidated financial statements.

In addition, the consolidated financial statements shall disclose the information as per the requirements specified in the applicable Accounting Standards including the following as per the requirements of Schedule III to the Companies Act, 2013 which contains the 'General Instructions for Preparation of Consolidated Financial Statements':

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i. Profit or loss attributable to "minority interest" and to owners of the parent in the statement of profit and loss shall be presented as allocation for the period.

ii. "Minority interests" in the balance sheet within equity shall be presented separately from the equity of the owners of the parent.

Students are also advised to refer the Schedule III to the Companies Act, 2013.

It may be noted that companies do not maintain any separate set of journal entries for 'Consolidated Set of Accounts'. Continuing the example of Reliance Industries Limited, Consolidated Financial Statements of Reliance Industries Limited is not based on "double entry book-keeping in the 'group books of accounts'", as there is no concept of 'group books of accounts'. Practically, Consolidated Financial Statements are prepared from the separate / standalone financial statements of each entity (parent / subsidiary) to which consolidation adjustments are made in accordance with AS 21. Accordingly, the financial statements of each entity are finalized in accordance with the applicable Accounting Standards, and based on such financial statements, consolidation procedures are performed in accordance with AS 21.

1.10 CONSOLIDATION PROCEDURES

Rule 6 of the Companies (Accounts) Rules, 2014 states that the manner of consolidation of financial statements of the company shall be in accordance with the provisions of Schedule III of the Act and the applicable accounting standards. AS 21, lays down the procedure for consolidation of financial statements of the companies within the group.

When preparing consolidated financial statements, the individual balances of the parent and its subsidiaries are combined or consolidated on a line-by-line basis, and then certain consolidation adjustments are made.

For example, the cash, trade receivables and prepayments of the parent and each subsidiary are added together to arrive at the cash, trade receivables and prepayments of the group, before consolidation adjustments are made.

The objective is that the consolidated financial statements should present the information contained in the consolidated financial statements of a parent and its subsidiaries as if they were the financial statements of a single economic entity.

The various steps involved in the consolidation process are as follows:

1. the cost to the parent of its investment (cost of acquisition) in each subsidiary and the parent's portion of equity of each subsidiary (acquirer's interest), at the date on which investment in each subsidiary is made, should be eliminated. In case, cost of acquisition exceeds or is less than the acquirer's interest, at the date on which investment in the subsidiary is made, goodwill or capital reserve should be recognized respectively in the CFS.

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2. intragroup transactions, including sales, expenses and dividends, are eliminated, in full;
3. Adjustments in respect of unrealised profits/ losses should be made;
4. minority interest in the net income of consolidated subsidiaries for the reporting period are identified and adjusted against the income of the group in order to arrive at the net income attributable to the owners of the parent; and
5. minority interests in the net assets of consolidated subsidiaries should be identified and presented in the consolidated balance sheet separately from liabilities and the equity of the parent's shareholders. Minority interests in the net assets consist of:
   i. the amount of equity attributable to minorities at the date on which investment in a subsidiary is made; and
   ii. the minorities share of movements in equity since the date the parent subsidiary relationship came in existence.

Note: Where the carrying amount of the investment in the subsidiary is different from its cost, the carrying amount is considered for the purpose of above computations.

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6. The results of operations of a subsidiary are included in the CFS as from the date on which parent-subsidiary relationship came in existence.
   The results of operations of a subsidiary with which parent-subsidiary relationship ceases to exist are included in the consolidated statement of profit and loss until the date of cessation of the relationship.
   The difference between the proceeds from the disposal of investment in a subsidiary and the carrying amount of its assets less liabilities as of the date of disposal is recognised in the consolidated statement of profit and loss as the profit or loss on the disposal of the investment in the subsidiary.
   In order to ensure the comparability of the financial statements from one accounting period to the next, supplementary information is often provided about the effect of the acquisition and disposal of subsidiaries on the financial position at the reporting date and the results for the reporting period and on the corresponding amounts for the preceding period.
7. An investment in an enterprise should be accounted for in accordance with AS 13, Accounting for Investments, from the date that the enterprise ceases to be a subsidiary and does not become an associate.
8. The carrying amount of the investment at the date that it ceases to be a subsidiary is regarded as cost thereafter.

Summarising the Above into simple steps (Logic would be explained in class)

Step 1: Identify who is holding and who is subsidiary company

Step 2: Identify the percentage of holding and the date of holding

Step 3: Analysis of reserves of subsidiary on the date of acquisition and classify as Pre and Post acquisition reserves

Step 4: Summarise all reserves as pre and post in a summary table

Step 5: Compute total Minority Interest

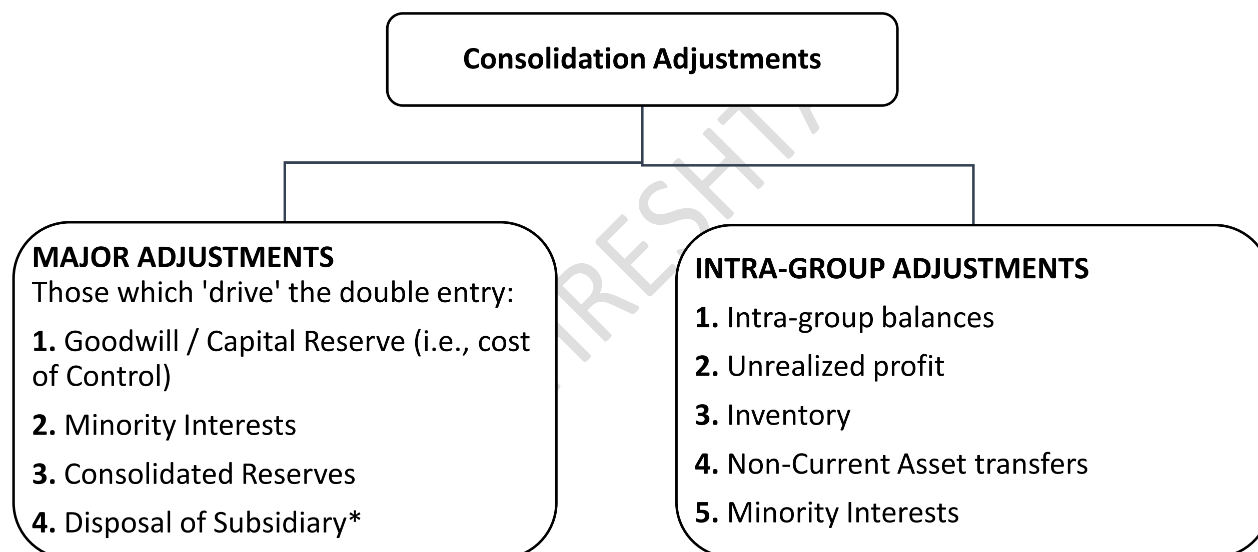
Step 6: Computation of cost of control / Goodwill or Capital Reserve

Step 7: Adjustment for Inter-company adjustments

Step 8: Computation of reserves for the purpose of Balance sheet

Step 9: Preparation of Consolidated balance sheet (Final solution)

Thus, Consolidation Adjustments are broadly categorized as under



* Disposal of Subsidiary is not examined at the Intermediate Level.

1.11. CALCULATION OF GOODWILL/CAPITAL RESERVE (COST OF CONTROL)

As on the date of investment, the cost of investment and the equity in the subsidiary needs to be calculated.

Equity is defined as the 'residual interest in the assets of an enterprise after deducting all its liabilities.' In other words, it is equal to the net worth of the enterprise.

Once the above is calculated, goodwill or capital reserve is calculated as under:

Goodwill = Cost of Investment - Parent's share in the equity of the subsidiary on date of investment

Capital Reserve = Parent's share in the equity of the subsidiary on date of investment – Cost of investment

The parent's portion of equity in a subsidiary, at the date on which investment is made, is determined on the basis of information contained in the financial statements of the subsidiary as on the date of investment.

However, if the financial statements of a subsidiary as on the date of investment are not available and if it is impracticable to draw the financial statements of the subsidiary as on that date, financial statements of the subsidiary for the immediately preceding period are used as a basis for consolidation.

Adjustments are made to these financial statements for the effects of significant transactions or other events that occur between the date of such financial statements and the date of investment in the subsidiary.

It may be mentioned that positive or negative differential is separately recognised only in purchase method. This differential calculated as cost of control is shown in the consolidated balance sheet.

A detailed illustration below will help in understanding the concept of goodwill / capital reserve.

Example 1

The following information is given as at 31 March 20X1

SHRESHTA

	P Ltd.	**S Ltd.**
Non-current Assets:		
PPE	2,000	500
Investment in Subsidiary	1,000	
Net Current Assets	2,000	500
	5,000	**1,000**
Issued Capital	500	1,000
Reserves and Surplus	4,500	
	5,000	**1,000**

P Ltd. acquired 100% of shares of S Ltd. on 31 March 20X1 for Rs. 1,000.

Since P Ltd. has acquired S Ltd., we will have to determine goodwill / capital reserve. Let us understand why goodwill / capital reserve arises in case of consolidation, and what would be the interpretation of the same.

In the given case, P Ltd. acquired all the shares of S Ltd. by paying Rs. 1,000. This payment (i.e., purchase consideration) would be made by P Ltd. to the shareholder(s) of S Ltd. (hence the transfer of this amount would not appear in the books of S Ltd.).

By paying Rs. 1,000, P Ltd. has acquired 'control' over S Ltd. This acquisition is quite different from the concept of amalgamation done in accordance with AS 14, though the concept of goodwill /

capital reserve is similar. Under AS 14, the target company would generally liquidate, and all assets and liabilities would be transferred from the Selling Company to the Purchasing Company. In case of consolidation, P Ltd. is acquiring 'control' i.e., by way of acquiring equity shares in S Ltd. Thus, S Ltd. continues to exist, and the assets and liabilities of S Ltd. are not transferred to P Ltd., but instead continue to remain with S Ltd. only. However, since in substance, acquisition has taken place (albeit through transfer of control), the purchase consideration of Rs. 1,000 will be compared with the net worth of S Ltd., which is Rs. 1,000. Since amount paid (i.e., purchase consideration) equals the net worth, no goodwill / capital reserve is recognized. In case the amount paid (i.e., purchase consideration) would be higher / lower than the net worth of S Ltd., such difference would be recognized in Goodwill / Capital Reserve respectively.

The calculation of goodwill is presented below:

Tangible Assets	**500**
Net Current Assets	500
	1,000
Less: Liabilities	NIL
Net Worth of S Ltd.	1,000
Investment in S Ltd. (purchase consideration)	1,000
Goodwill / (Capital Reserve)	**NIL**

SHRESHTA

Example 2

Modifying example 1, the following information is given as at 31 March 20X1

	P Ltd.	**S Ltd.**
Non-current Assets:		
PPE	2,000	500
Investment in Subsidiary	1,000	
Net Current Assets	2,000	500
	5,000	**1,000**
Issued Capital	500	700#
Reserves and Surplus	4,500	300#
	5,000	**1,000**

As compared to Example 1 – There is a difference in the break-up of net worth of S Ltd. (Example 1 – Issued capital was 1,000 and Reserves and Surplus was Nil; The Net worth is 1,000).

P Ltd. acquired 100% of shares of S Ltd. on 31 March 20X1 for Rs. 1,000.

Like Example 1 above P Ltd. has acquired 'control' over S Ltd. by paying Rs. 1,000. Accordingly, the purchase consideration of Rs. 1,000 will be compared with the net worth of S Ltd. which is Rs. 1,000. Since amount paid (i.e., purchase consideration) equals the net worth, no goodwill / capital reserve is recognized. In case the amount paid (i.e., purchase consideration) would be higher / lower than the net worth of S Ltd., such difference would be recognized in Goodwill / Capital Reserve respectively.

The calculation of goodwill is presented below:

Tangible Assets	**500**
Net Current Assets	500
	1,000
Less: Liabilities	NIL
Net Worth of S Ltd.	1,000
Investment in S Ltd. (purchase consideration)	1,000
Goodwill / (Capital Reserve)	**NIL**

SHRESHTA

Example 3

Modifying example 2, the following information is given as at 31 March 20X1

	P Ltd.	**S Ltd.**
Non-current Assets:		
PPE	2,000	500
Investment in Subsidiary	1,200	
Net Current Assets	2,000	500
	5,200	**1,000**
Issued Capital	700	700
Reserves and Surplus	4,500	300
	5,200	**1,000**

P Ltd. acquired 100% of shares of S Ltd. on 31 March 20X1 for Rs. 1,200.

Like Examples 1 and 2 above P Ltd. has acquired 'control' over S Ltd. by paying Rs. 1,200. Accordingly, the purchase consideration of Rs. 1,200 will be compared with the net worth of S Ltd. which is Rs.1,000. Since amount paid (i.e., purchase consideration) exceeds the net worth, such excess of is recognized as goodwill. In case the amount paid (i.e., purchase consideration) would be lower than the net worth of S Ltd., such difference would be credited to Capital Reserve.

The calculation of goodwill is presented below:

Tangible Assets	**500**
Net Current Assets	500
	1,000
Less: Liabilities	NIL
Net Worth of S Ltd.	1,000
Investment in S Ltd. (purchase consideration)	1,200
Goodwill / (Capital Reserve)	**200**

1.12 MINORITY INTERESTS

Minority interest is that part of the net assets of a subsidiary attributable to interest which is held by outsiders.

Minority interests in the net income of consolidated subsidiaries for the reporting period are identified and adjusted against the income of the group in order to arrive at the net income attributable to the shareholders of the holding company.

Minority interests should be presented in the consolidated balance sheet separately from liabilities and the equity of the parent's shareholders.

Minority interest in the income of the group should be separately presented in the consolidated income statement.

Minority interests in the net assets consist of:

i. The amount of equity attributable to minorities at the date on which investment in a subsidiary is made and

ii. The minorities' share of movements in equity since the date the parent subsidiary relationship came in existence.

The losses applicable to the minority in a consolidated subsidiary may exceed the minority interest in the equity of the subsidiary. The excess, and any further losses applicable to the minority, are adjusted against the majority interest except to the extent that the minority has a binding obligation to and is able to make good the losses. If the subsidiary subsequently reports profit, all such profits are allocated to the majority interest until the minority's share of losses previously absorbed by the majority has been recovered.

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Example 4

Modifying Example 2, the following information is given as at 31 March 20X1:

	P Ltd.	S Ltd.
Non-current Assets:		
Tangible Assets	2,000	500
Investment in Subsidiary	1,000	
Net Current Assets	2,000	500
	5,000	**1,000**
Issued Capital	500	700
Reserves and Surplus	4,500	300
	5,000	**1,000**

P Ltd. acquired 80% of shares of S Ltd. on 31 March 20X1 for Rs. 1,000.

In the given case, P Ltd. acquired 80% of the shares of S Ltd. by paying Rs. 1,000. This payment (i.e., purchase consideration) would be made by P Ltd. to the shareholder(s) of S Ltd.

By paying Rs. 1,000, P Ltd. has acquired 'control' over S Ltd. We cannot say that P Ltd. has acquired only '80% control', since its shareholding in S Ltd. will enable it to take all the decisions regarding S Ltd.'s operations and usage of assets and repayment of liabilities. However, the fact remains that 20% stake does NOT belong to S Ltd. It belongs to outsiders, who are called 'Minority Interest' in accordance with AS 21. Accordingly, in this case, the purchase consideration of Rs. 1,000 will be compared with 80% of the net worth of S Ltd. Any excess or deficit would be recorded as goodwill / capital reserve respectively. 20% of the net worth on the date of acquisition would be recorded separately as Minority Interest. AS 21 defines Minority Interest as that part of the net results of operations and of the net assets of a subsidiary attributable to interests which are not owned, directly or indirectly through subsidiary(ies), by the parent. As per Schedule III to the Companies Act, 2013, "Minority Interests" in the balance sheet within equity shall be presented separately from the equity of the owners of the parent.

In the given case, the calculation of goodwill is presented below:

Tangible Assets : 80% being share of parent	**400**
Net Current Assets: 80% being share of parent	400
	800
Less: Liabilities	NIL
Net Worth of S Ltd.	800
Investment in S Ltd. (purchase consideration)	1,000
Goodwill / (Capital Reserve)	**200**

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1.13. PROFIT OR LOSS OF SUBSIDIARY COMPANY

For the purpose of consolidated balance sheet preparation, all reserves and profits (or losses) of subsidiary company should be classified into **pre and post acquisition reserves and profits (or losses).**

Profits (or losses) earned (or incurred) by subsidiary company up to the date of acquisition of the shares by the holding company are pre acquisition or capital profits (or loss).

Similarly, all reserves of subsidiary company up to the date of acquisition are capital reserves from the view point of holding company. If the holding interest in subsidiary is acquired during the middle or some other period of the current year, pre-acquisition profit should be calculated accordingly.

The minority interest in the reserves and profits (or losses) of subsidiary company should be transferred to minority interest account which will also include share capital of subsidiary company held by outsiders / minority shareholders.

Minority Interest = Share Capital of subsidiary belonging to outsiders + Minority interest in reserves and profits of subsidiary company

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The holding company's interest in the pre-acquisition reserves and profits (or losses) should be adjusted against cost of control to find out goodwill or capital reserve on consolidation. The reserves and profits (or loss) of subsidiary company, representing holding company's interest in post-acquisition or revenue reserves and profits (or losses), should be added to the reserves and profits (or losses) of holding company.

1.14 CONSOLIDATION ADJUSTMENTS

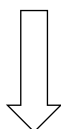
A. REVALUATION OF ASSETS OF SUBSIDIARY COMPANY

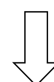
It may be possible that the fair value of the assets of the subsidiary may be different from the book value. Hence, the parent may choose to perform a revaluation of the assets of the subsidiary for the purposes of consolidation. It may be noted that such revaluation is not performed in the standalone / separate financial statements of the subsidiary. The profit or loss on revaluation of fixed assets of subsidiary should also be treated as capital profit or loss. But if the fall in the value of the asset occurs after the date of acquisition, the loss should be treated as revenue loss. Adjustment for depreciation would be made in the profit and loss account of the subsidiary. Depreciation on changed value of the assets shall be given effect to.

Depreciation on revalued assets will be taken as capital or revenue depending on the period for which the depreciation belongs to. Hence the period for depreciation is important to be considered.

Property, Plant and Equipment (PPE)

Initial Recognition	Subsequent Measurement
Fair Value (-) Carrying Amount (As on the date of acquisition)	Additional Depreciation would arise in case of initial upward or Reversal of excess depreciation would arise in case of initial downward valuation.





PPE A/c	Dr.	xxx		**Post** P/L	Dr.	xxx	
To **Pre**- P/L			xxx	To PPE			xxx
(In case of upward revaluation)				(Additional depreciation)			
Pre- P/L	Dr.	xxx		PPE	Dr.	xxx	
To PPE			xxx	To **Post** P/L			xxx
(In case of downward revaluation)				(Reversal of excess depreciation)			

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1. The above entries are not recorded in the standalone books of either the subsidiary or the parent. These entries are only for understanding the impact in the consolidated financial statements and as such, only the effect of such entries will appear in the consolidated financial statements (and not the standalone / separate financial statements).
2. It is presumed that the subsidiary does not follow the revaluation model for accounting of fixed assets. If it had to follow, then the standalone balance sheet of the subsidiary would already contain the impact of the revaluation.

The debit /credit on account of revaluation could alternatively be taken to the Revaluation Reserve or the P/L depending on whether it is a first -time upward / downward revaluation. However, as ultimately the reserves have to be analyzed between pre- and post-acquisition for the purposes of consolidation, the nature of reserves is irrelevant.

Example 5

H Ltd. acquires 70% of the equity shares of S Ltd. on 1.1.20X1. On that date, paid up capital of S Ltd. was 10,000 equity shares of Rs. 10 each; accumulated reserve balance was Rs. 1,00,000. H Ltd. paid Rs. 1,60,000 to acquire 70% interest in the S Ltd. Assets of S Ltd. were revalued on 1.1.20X1 and a revaluation loss of Rs. 20,000 was ascertained. The book value of shares of S Ltd. is calculated as shown below:

	Rs.
70% of the Equity Share Capital Rs. 1,00,000	70,000
70% of Accumulated Reserve Rs. 1,00,000	70,000
70% of Revaluation Loss Rs. 20,000	(14,000)
	1,26,000

So, H Ltd. paid a positive differential of Rs. 34,000 i.e. Rs. (1,60,000 – 1,26,000). This differential is called goodwill and is shown in the balance sheet under the head intangibles.

Example 6

A Ltd. acquired 70% interest in B Ltd. on 1.1.20X1. On that date, B Ltd. had paid-up capital of Rs.1,00,000 consisting of 10,000 equity shares of Rs. 10 each and accumulated balance in reserve and surplus of Rs.1,00,000. On that date, assets and liabilities of B Ltd. were also revalued and revaluation profit of Rs. 20,000 was calculated. A Ltd. paid Rs. 1,30,000 to purchase the said interest. In this case, the book value of Shares of B Ltd. is calculated as shown below:

	Rs.
70% of the Equity Share Capital Rs. 1,00,000	70,000
70% of Accumulated Reserve Rs. 1,00,000	70,000
70% of Revaluation Loss Rs. 20,000	(14,000)
	1,54,000

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In this case, a negative differential of Rs. 24,000 arises i.e. (1,54,000 – 1,30,000) which is called and presented as capital reserve.

Example 7

H Ltd. acquired 16,000 equity shares of Rs. 10 each, in S Ltd. on October 1, 20X1 for Rs. 3,06,800. The profit and loss account of S Ltd. showed a balance of Rs.10,000 on April 1,20X1. The plant and machinery of S Ltd. which stood in the books at Rs. 1,50,000 on April 1,20X1 was considered worth Rs. 1,80,000 on the date of acquisition.

The information of the two companies as at 31-3-20X2 was as follows:

	H Ltd.(Rs.)	S Ltd. (Rs.)
Shares capital (fully paid equity shares of Rs. 10 each)	5,00,000	2,00,000
General reserve	2,40,000	1,00,000
Profit and loss account	57,200	82,000
Current Liabilities	1,69,800	33,000

Land and building	1,80,000	1,90,000
Plant and machinery	2,40,000	1,35,000
Investments	3,06,800	
Current assets	2,40,200	90,000

In this case,

Percentage of holding:

		No. of Shares	Percentage
Holding Co.	:	16,000	(80%)
Minority shareholders	:	4,000	(20%)
TOTAL SHARES		20,000	

Impact of Revaluation of Plant and Machinery will be as –

	Rs.
Book value of Plant and Machinery as on 01-04-20X1	1,50,000
Depreciation Rate $\left(\frac{1,50,000 - 1,35,000}{1,50,000}\right) = 15,000 / 1,50,000 \times 100$	10%
Book value of Plant and Machinery as on 01-10-20X1 after six months depreciation @10% (1,50,000-7,500)	1,42,500
Revalued at	1,80,000
Revaluation profit (1,80,000-1,42,500)	37,500
Share of H Limited in Revaluation Profit (80%)	30,000
Share of Minority in Revaluation profit (20%)	7,500
Additional Depreciation on appreciated value to be charged from post-acquisition profits (10% of Rs.1,50,000 for 6 months) + (10% of Rs.1,80,000 for 6 months) less Rs.15,000 (as already charged)	1500
Share of H Limited in additional depreciation that will reduce its share (80%) in post-acquisition profit by	1,200
Share of Minority Interest in additional depreciation	300

B. DIVIDEND RECEIVED FROM SUBSIDIARY(IES)

As per AS 13, 'Accounting for Investments', Interest, dividends and rentals receivables in connection with an investment are generally regarded as income, being the return on the investment.

However, in some circumstances, such inflows represent a recovery of cost and do not form part of income.

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Example: When unpaid interest has accrued before the acquisition of an interest bearing investment and is therefore included in the price paid for the investment, the subsequent receipt of interest is allocated between pre-acquisition and post-acquisition periods; the pre-acquisition portion is deducted from cost.

When dividends on equity are declared from pre-acquisition profits, a similar treatment (i.e. as mentioned above) may apply. If it is difficult to make such an allocation except on an arbitrary basis, the cost of investment is normally reduced by dividends receivable only if they clearly represent a recovery of a part of the cost.

When holding company receives dividend from a subsidiary company, it must distinguish between the part received out of capital profits (i.e. pre-acquisition profits) and revenue profits (i.e. post-acquisition profits); capital profits are credited to Investment account (being capital receipts) and revenue profits are credited to the Profit & Loss Account.

If the controlling interest was acquired during the course of a year, profit for that year must be apportioned into the pre-acquisition and post-acquisition portions, on the basis of time in the absence of information on the point.

It must be understood that the term 'capital profit', in this context, apart from the generic meaning of the term, connotes profit earned by the subsidiary company till the date of acquisition. As a result, profits which may be of revenue nature for the subsidiary company may be capital profits so far as the holding company is concerned.

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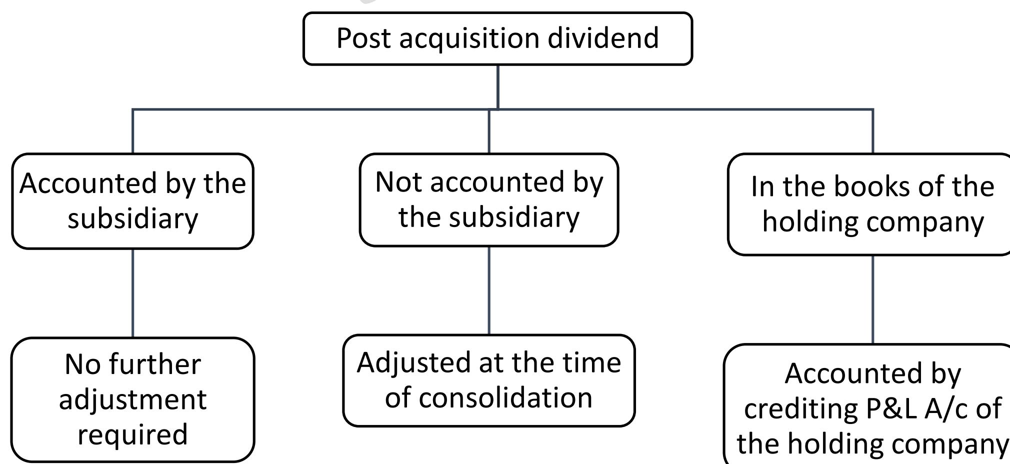
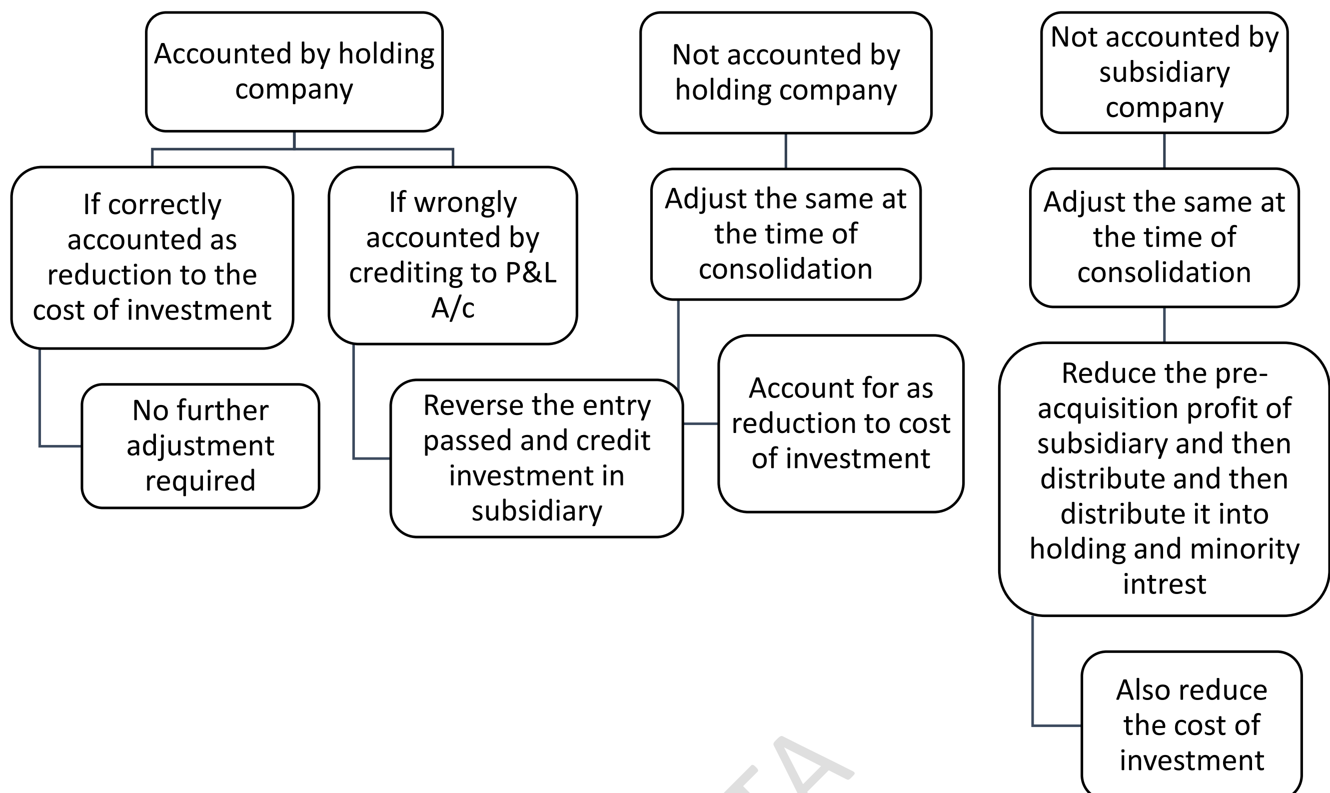
Treatment in case of post-acquisition dividend



Treatment in case of pre-acquisition dividend



Dividends received out of profits earned before purchase of investments normally also are credited to the Investment Account.

Example 8

If shares in X Ltd., are purchased in January 20X2 and in April 20X2, X Ltd., declares a dividend in respect of 20X1, the dividend received by the holder of the shares correctly should not be treated as income but as capital receipt and credited to Investment Account.

Note: In case of issue of bonus shares by the subsidiary company, the holding company, like other holders, record no entry; only the number of shares held is increased.

(Refer Illustration 1 - 13)

C. ELIMINATION OF INTRA-GROUP TRANSACTIONS

Consolidated Financial Statements reflect the financial position and operations of the group as a single entity. Accordingly, the statements must contain only those transactions and balances with entities 'external' to the group, thereby requiring elimination of intra-group transactions.

In order to present financial statements for the group in a consolidated format, the effect of transactions between group enterprises should be eliminated. Para 16 of AS 21 states that intragroup balances and intragroup transactions and resulting unrealized profits should be eliminated in full. Unrealized losses resulting from intragroup transactions should also be eliminated unless cost cannot be recovered.

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Liabilities due to one group enterprise by another will be set off against the corresponding asset in the other group enterprise's financial statements; sales made by one group enterprise to another should be excluded both from turnover and from cost of sales or the appropriate expense heading in the consolidated statement of profit and loss.

To the extent that the buying enterprise has further sold the goods in question to a third party, the eliminations to sales and cost of sales are all that is required, and no adjustments to consolidated profit or loss for the period, or to net assets, are needed. However, to the extent that the goods in question are still on hand at year end, they may be carried at an amount that is in excess of cost to the group and the amount of the intra-group profit must be eliminated, and assets are reduced to cost to the group.

For transactions between group enterprises, unrealized profits resulting from intra-group transactions that are included in the carrying amount of assets, such as inventories and tangible fixed assets, are eliminated in full. The requirement to eliminate such profits in full applies to the transactions of all subsidiaries that are consolidated – even those in which the group's interest is less than 100%.

Unrealized profit in inventories: Where a group enterprise sells goods to another, the selling enterprise, as a separate legal enterprise, records profits made on those sales. If these goods are still held in inventory by the buying enterprise at the year end, the profit recorded by the selling enterprise, when viewed from the standpoint of the group as a whole, has not yet been earned, and will not be earned until the goods are eventually sold outside the group. On consolidation, the unrealized profit on closing inventories will be eliminated from the group's profit, and the closing inventories of the group will be recorded at cost to the group.

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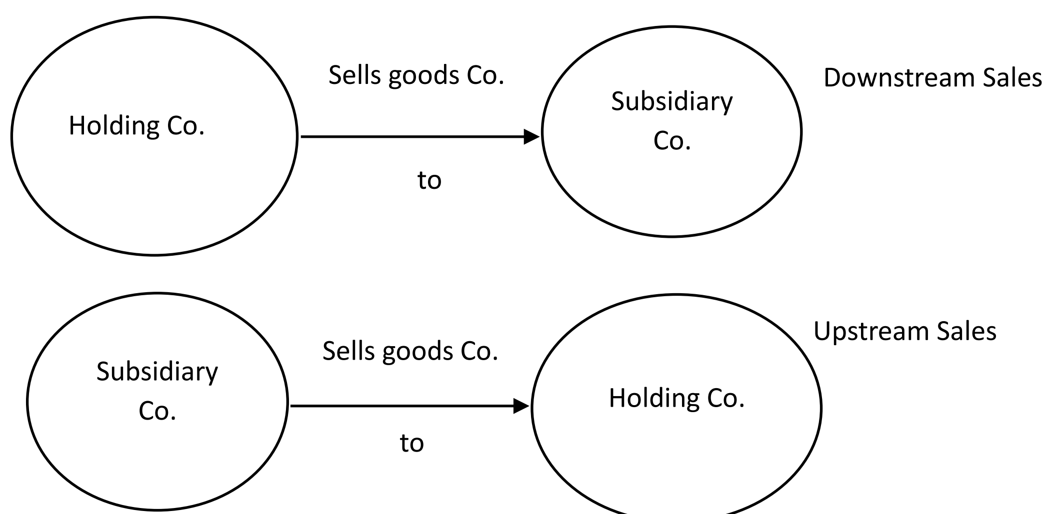
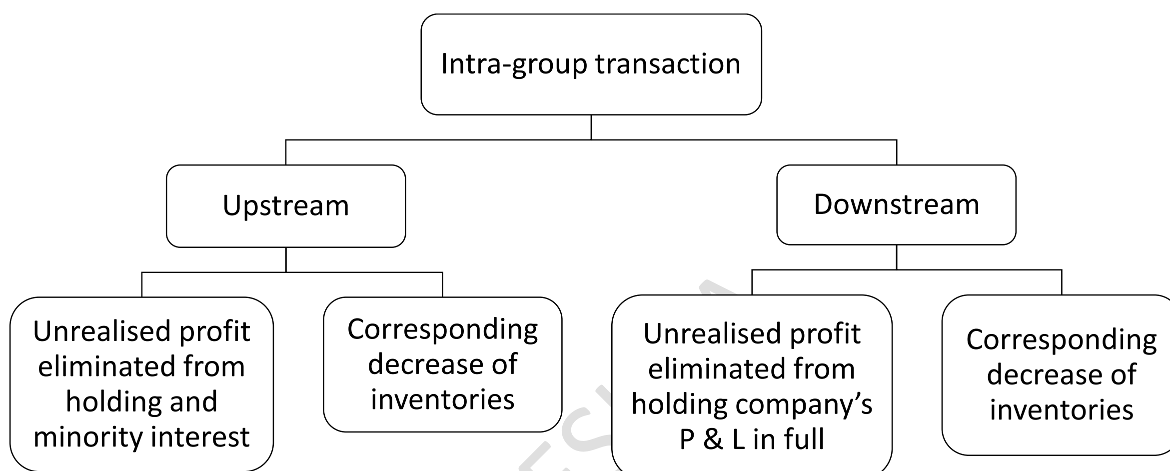
Here, the point to be noted is that one has to see whether the intragroup transaction is "upstream" or "down-stream". **Upstream transaction** is a transaction in which the subsidiary company sells goods to holding company. While in the **downstream transaction** holding company is the seller and subsidiary company is the buyer.



In the case of upstream transaction, since the goods are sold by the subsidiary to holding company; profit is made by the subsidiary company, which is ultimately shared by the holding company and the minority shareholders. In such a transaction, if some goods remain unsold at the balance sheet date, the unrealized profit on such goods should be eliminated from minority interest as well as from consolidated profit on the basis of their share-holding besides deducting the same from unsold inventory.

But in the case of downstream transaction, the whole profit is earned by the holding company, therefore, whole unrealized profit should be adjusted from unsold inventory and consolidated profit and loss account only irrespective of the percentage of the shares held by the parent.



Unrealized profit on transfer of non-current asset: Similar to the treatment described above for unrealized profits in inventories, unrealized inter-company profits arising from intra-group transfers of fixed assets are also eliminated from the consolidated financial statements.

Unrealized losses: Unrealized losses resulting from intra-group transactions that are deducted in arriving at the carrying amount of assets are also eliminated **unless cost cannot be recovered.**

Example:

If net realizable value (NRV) expected from sale of such goods is more than the actual cost of the goods, then unrealized loss should be reversed during consolidation process. However, if it is expected that NRV would not be sufficient to recover the loss incurred on transfer of goods from one entity to another, the unrealized loss should not be reversed.

(Refer Illustration 14)

D. ALIGNMENT OF REPORTING DATES

The financial statements used in the consolidation should be drawn up to the same reporting date. If it is not practicable to draw up the financial statements of one or more subsidiaries to such date and, accordingly, those financial statements are drawn up to different reporting dates, adjustments should be made for the effects of significant transactions or other events that occur between those dates and the date of the parent's financial statements.

In any case, the difference between reporting dates should not be more than six months.

The financial statements of the parent and its subsidiaries used in the preparation of the consolidated financial statements are usually drawn up to the same date. When the reporting dates are different, the subsidiary often prepares, for consolidation purposes, statements as at the same date as that of the parent.

When it is impracticable to do this, financial statements drawn up to different reporting dates may be used provided the difference in reporting dates is not more than six months.

The consistency principle requires that the length of the reporting periods and any difference in the reporting dates should be the same from period to period.

1.15 PREPARATION OF CONSOLIDATED STATEMENT OF PROFIT AND LOSS

All the items of profit and loss account are to be added on line by line basis and inter-company transactions should be eliminated from the consolidated figures.

For example, a holding company may sell goods or services to its subsidiary, receive consultancy fees, commission, royalty etc. These items are included in sales and other income of the holding company and in the expense items of the subsidiary. Alternatively, the subsidiary may also sell goods or services to the holding company. These inter-company transactions are to be eliminated in full.

If there remains any unrealized profit in the inventory, of any of the Group Company, such unrealized profit is to be eliminated from the value of inventory to arrive at the consolidated profit.

(Refer Illustration 15)

1.16 PREPARATION OF CONSOLIDATED CASH FLOW STATEMENT

As per AS 21, Consolidated cash flow statement is presented in case a parent presents its own cash flow statement.

For the purpose of preparation of consolidated cash flow statement, all the items of cash flow from operating activities, investing activities and financing activities are to be added on line by line basis and from the consolidated items, inter - company transactions should be eliminated. Below given is an illustrative consolidated cash flow statement with hypothetical figures:

Consolidated Cash Flow Statement (Illustrative only)

		(Rs. in million)	
	A Company	**B Company**	**Total**
Cash Flows from Operating Activities			
Change in Reserve	8	2	10

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Change in P & L A/c	-	1	1
Dividend Paid	22	-	22
Tax Provision	20	1	21
Depreciation	10	5	15
Interest	(10)	10	-
	50	19	69
Less: Tax payment	(20)	(1)	(21)
	30	18	48
Working capital adjustment (A)	(13)	12	(1)
	17	30	47
Cash Flows from Investment Activities			
Sale of fixed assets	30	-	30
Purchase of fixed assets (B)	(30)	(20)	(50)
	-	(20)	(20)
Cash Flows from Financing Activities (C)	(5)	(10)	(15)
Net cash flows	**12**	**-**	**12**

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1.17 UNIFORM ACCOUNTING POLICIES

Para 20 of AS 21 states that consolidated financial statements shall be prepared using uniform accounting policies for like transactions and other events in similar circumstances.

If any company in the same group uses accounting policies other than those adopted in consolidated financial statements for like transactions and events in similar circumstances, appropriate adjustments are made to its financial statements when they are used in preparing the consolidated financial statements.

If it is not practicable to use uniform accounting policies in preparing the consolidated financial statements, the fact should be disclosed together with the proportions of items to which different accounting policies have been applied.

For example, if the subsidiary company follows weighted average method for valuation of inventories and the holding company follows FIFO method, the financial statements of subsidiary company should be restated by adjusting the value of inventories to bring the same in line with the valuation procedure adopted by the holding company. After that consolidation should be done.

(Refer Illustration 16)

1.18 TREATMENT OF SUBSIDIARY COMPANY HAVING PREFERENCE SHARE CAPITAL

While preparing CFS, outstanding cumulative preference shares issued by a subsidiary are considered in the same manner as any other liability, such as debentures etc. Accordingly, the cost associated with such cumulative preference shares needs to be adjusted for.

Therefore, while computing its share of profits or losses of the subsidiary, the parent should make adjustments in respect of preference dividends on outstanding cumulative preference shares issued by a subsidiary and held outside the group since, for the group, such preference shares represent external liabilities. It would be appropriate for the parent to compute its share of profits or losses after adjusting for subsidiary's cumulative preference dividends, whether or not profits are available or dividends have been declared.

However, in case of non-cumulative preference shares, no such adjustment is required unless the dividend is actually received.

SUMMARY

- "Holding company", in relation to one or more other companies, means a company of which such companies are subsidiary companies; "subsidiary company" or "subsidiary", in relation to any other company (that is to say the holding company), means a company in which the holding company—
  - controls the composition of the Board of Directors; or
  - exercises or controls more than one-half of the total share capital either at its own or together with one or more of its subsidiary companies: Provided that such class or classes of holding companies as may be prescribed shall not have layers of subsidiaries beyond such numbers as may be prescribed.
- 'Total share capital', as defined in section 2(87) (ii) above, has been further clarified by the Rule 2(1)(r) of the Companies (Specification of Definitions Details) Rules, 2014. As per the Rule, total share capital includes
  - paid up equity share capital
  - convertible preference share capital.
- Consolidated financial statements are prepared and presented by a parent/holding enterprise to provide financial information about a parent and its subsidiary (ies) as a single economic entity.
- Distinction must be made from the point of view of the holding company, between revenue and capital profit of the subsidiary. In the absence of information, profits of a year may be treated as accruing from day to day.

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Preparation of Consolidated Statement of Profit and Loss

- All the revenue items are to be added on line by line basis and from the consolidated revenue items, inter-company transactions should be eliminated.
- If there remains any unrealized profit in the inventory of goods, of any of the Group Company, such unrealized profit should be eliminated from the value of inventory to arrive at the consolidated profit.

Preparation of Consolidated Cash Flow Statement

All the items of Cash flow from operating activities, investing activities and financing activities are to be added on line by line basis and from the consolidated items, inter-company transactions should be eliminated.

The financial statements used in the consolidation should be drawn up to the same reporting date. If it is not practicable to draw up the financial statements of one or more subsidiaries to such date and, accordingly, those financial statements are drawn up to different reporting dates, adjustments should be made for the effects of significant transactions or other events that occur between those dates and the date of the parent's financial statements.

In any case, the difference between reporting dates should not be more than six months.

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ILLUSTRATIONS

Illustration 1

From the following data, determine in each case:

1. **Minority interest at the date of acquisition and at the date of consolidation.**
2. **Goodwill or Capital Reserve.**
3. **Amount of holding company's profit in the consolidated Balance Sheet assuming holding company's own Profit & Loss Account to be Rs. 2,00,000 in each case:**

Case	Subsidiary Company	% shares owned	Cost Rs.	Date of acquisition 1.1.20X1		Consolidation Date 31.12.20X1	
				Share Capital Rs.	Profit & Loss Account Rs.	Share Capital Rs.	Profit & Loss Account Rs.
Case 1	A	90%	1,40,000	1,00,000	50,000	1,00,000	70,000
Case 2	B	85%	1,04,000	1,00,000	30,000	1,00,000	20,000
Case 3	C	80%	56,000	50,000	20,000	50,000	20,000
Case 4	D	100%	1,00,000	50,000	40,000	50,000	55,000

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Solution

1. Minority Interest = Equity attributable to minorities
   Equity is the residual interest in the assets of an enterprise after deducting all its liabilities i.e. in this case it should be equal to Share Capital + Profit & Loss A/c

	Minority % Shares Owned [E]	Minority interest as at the date of acquisition [E] x [A + B] Rs.	Minority interest as at the date of consolidation [E] X [C + D] Rs.
Case 1 [100-90]	10 %	15,000	17,000
Case 2 [100-85]	15 %	19,500	18,000
Case 3 [100-80]	20 %	14,000	14,000
Case 4 [100-100]	NIL	Nil	Nil

A = Share capital on 1.1.20X1

B = Profit & loss account balance on 1.1.20X1

C = Share capital on 31.12.20X1

D = Profit & loss account balance on 31.12.20X1

2. Calculation of Goodwill or Capital Reserve

	Shareholding % [F]	Cost [G]	Total Equity [A] + [B] = [C]	Parent's Portion of equity [F] x [C] =H	Goodwill Rs. [G] – [H]	Capital Reserve Rs. [H] – [G]
Case 1	90 %	1,40,000	1,50,000	1,35,000	5,000	—
Case 2	85 %	1,04,000	1,30,000	1,10,500	—	6,500
Case 3	80 %	56,000	70,000	56,000	Nil	Nil
Case 4	100 %	1,00,000	90,000	90,000	10,000	—

3. The balance in the Profit & Loss Account on the date of acquisition (1.1.20X1) is Capital profit, as such the balance of Consolidated Profit & Loss Account shall be equal to Holding Co.'s profit. On 31.12.20X1 in each case the following amount shall be added or deducted from the balance of holding Co.'s Profit & Loss account.

	% Share holding [K]	P & L as on 1.1.20X1 [L]	P & L as on consolidation date [M]	P & L as on consolidation date [N] = [M]-[L]	Amount to be added / (deducted) from holding's P & L [O] = [K] x [N]
1	90 %	50,000	70,000	20,000	18,000
2	85 %	30,000	20,000	(10,000)	(8,500)
3	80 %	20,000	20,000	NIL	NIL
4	100 %	40,000	55,000	15,000	15,000

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Illustration 2

XYZ Ltd. purchased 80% shares of ABC Ltd. on 1st January, 20X1 for Rs. 1,40,000. The issued capital of ABC Ltd., on 1st January, 20X1 was Rs. 1,00,000 and the balance in the Profit & Loss Account was Rs. 60,000.

During the year ended 31st December, 20X1, ABC Ltd. earned a profit of Rs. 20,000 and at year end, declared and paid a dividend of Rs. 15,000.

Show by an entry how the dividend should be recorded in the books of XYZ Ltd.

What is the amount of minority interest as on 1st January, 20X1 and 31st December, 20X1? Also please check whether there should be any goodwill/ capital reserve at the date of acquisition.

Solution

Total dividend paid is Rs. 15,000 (assumed to be out of post-acquisition profits), hence dividend received by XYZ will be credited to P & L.

XYZ Ltd.'s share of dividend = Rs. 15,000 X 80% = Rs. 12,000

In the books of XYZ Ltd.

	Rs.	Rs.
Bank A/c Dr.	12,000	
To Profit & Loss A/c		12,000
(Dividend received from ABC Ltd credited to P&L A/c being out of post-acquisition profits – as explained above)		
Goodwill on consolidation (at the date of acquisition):	Rs.	Rs.
Cost of shares		1,40,000
Less: Face value of capital i.e. 80% of capital	80,000	
Add: Share of capital profits [60,000X 80 %]	48,000	(1,28,000)
Goodwill		12,000
Minority interest on:		
- 1st January, 20X1:		
20% of Rs. 1,60,000 [1,00,000 + 60,000]		32,000
- 31st December, 20X1:		
20% of Rs. 1,65,000 [1,00,000 + 60,000 + 20,000 – 15,000]		33,000

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Illustration 3

Exe Ltd. acquires 70% of equity shares of Zed Ltd. as on 31st March, 20X1 at a cost of Rs. 70 lakhs.

The following information is available from the balance sheet of Zed Ltd. as on 31st March, 20X1:

	Rs. in lakhs
Property, plant and equipment	**120**
Investments	**55**
Current Assets	**70**
Loans & Advances	**15**
15% Debentures	**90**
Current Liabilities	**50**

The following revaluations have been agreed upon (not included in the above figures):

Property, plant and equipment Up by 20%

Investments Down by 10%

Zed Ltd. declared and paid dividend @ 20% on its equity shares as on 31st March, 20X1 (Face value - Rs. 10 per share). Exe Ltd. purchased the shares of Zed Ltd. @ Rs. 20 per share.

Calculate the amount of goodwill/capital reserve on acquisition of shares of Zed Ltd.

Solution

Revalued net assets of Zed Ltd. as on 31st March, 20X1

	Rs. in lakhs	**Rs. in lakhs**
Property, plant and equipment [120 X 120%]		144.0
Investments [55 X 90%]		49.5
Current Assets		70.0
Loans and Advances		15.0
Total Assets after revaluation		278.5
Less: 15% Debentures	90.0	
Current Liabilities	50.0	(140.0)
Equity / Net Worth		138.5
Exe Ltd.'s share of net assets (70% of 138.5)		96.95
Exe Ltd.'s cost of acquisition of shares of Zed Ltd.		
(Rs. 70 lakhs – Rs. 7 lakhs*)		63.00
Capital reserve		33.95

* Total Cost of 70 % Equity of Zed Ltd	Rs. 70 lakhs
Purchase Price of each share	Rs. 20
Number of shares purchased [70 lakhs /Rs. 20]	3.5 lakhs
Dividend @ 20 % i.e. Rs. 2 per share	Rs. 7 lakhs

Since dividend received is for pre-acquisition period, it has been reduced from the cost of investment in the subsidiary company.

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Illustration 4

A Ltd. acquired 70% of equity shares of B Ltd. on 1.4.20X1 at cost of Rs. 10,00,000 when B Ltd. had an equity share capital of Rs. 10,00,000 and reserves and surplus of Rs. 80,000. In the four consecutive years, B Ltd. fared badly and suffered losses of Rs. 2,50,000, Rs. 4,00,000, Rs. 5,00,000 and Rs. 1,20,000 respectively. Thereafter in 20X5- X6, B Ltd. experienced turnaround and registered an annual profit of Rs. 50,000. In the next two years i.e. 20X6-X7 and 20X7-X8, B Ltd. recorded annual profits of Rs. 1,00,000 and Rs. 1,50,000 respectively. Show the minority interests and cost of control at the end of each year for the purpose of consolidation.

Solution

The losses applicable to the minority in a consolidated subsidiary may exceed the minority interest in the equity of the subsidiary. In such cases, AS 21 prescribes that the excess, and any further losses applicable to the minority, are adjusted against the majority interest except to the extent that the

minority has a binding obligation to, and is able to, make good the losses. If the subsidiary subsequently reports profits, all such profits are allocated to the majority interest until the minority's share of losses previously absorbed by the majority has been recovered.

Where the minority interest has a binding obligation (say by way of a shareholders' agreement), then the share of losses will be attributed to the minority interest even if it exceeds the minority interest in the equity (i.e., debit balance in minority interest). Since information on the existence of a binding obligation is not given in the question, we solve as if such obligation does not exist, and hence the minority interests will be computed as follows:

Year	Profit/(Loss)	Minority Interest (30%)	Additional Consolidated P & L (Dr.) Cr. (for the year ended balance)	Minority's Share of losses borne by A Ltd.		Cost of Control
				Rs.	Balance	
At the time of acquisition in 20X1		3,24,000 - (W.N.)	-			
20X1-X2	(2,50,000)	(75,000)	(1,75,000)			2,44,000 (W.N.)
Balance		2,49,000				
20X2-X3	(4,00,000)	(1,20,000)	(2,80,000)			2,44,000
Balance		1,29,000				
20X3-X4	(5,00,000)	(1,50,000)	(3,50,000)			2,44,000
		(21,000)				
	Loss of minority borne by Holding Co.	21,000	(21,000)	21,000	21,000	
Balance		Nil	(3,71,000)			
20X4-X5	(1,20,000)	(36,000)	(84,000)			2,44,000
	Loss of minority borne by Holding Co.	36,000	(36,000)	36,000	57,000	
Balance		Nil	(1,20,000)			
20X5-X6	50,000	15,000	35,000			2,44,000
	Profit share of					

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	minority adjusted against losses of minority absorbed by Holding Co.	(15,000)	15,000	(15,000)	42,000	
Balance		Nil	50,000			
20X6-X7	1,00,000	30,000	70,000			
	Profit share of minority adjusted against losses of minority absorbed by Holding Co.	(30,000)	30,000	(30,000)	12,000	2,44,000
Balance		Nil	100,000			
20X7-X8	1,50,000	45,000	1,05,000	(12,000)	Nil	
		(12,000)	12,000			2,44,000
Balance		33,000	1,17,000			

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Working Note:

Calculation of Minority interest and Cost of control on 1.4.20X1

		Share of Holding Co.	Minority Interest
	100%	**70%**	**30%**
	(Rs.)	**(Rs.)**	**(Rs.)**
Share Capital	10,00,000	7,00,000	3,00,000
Reserve	80,000	56,000	24,000
		7,56,000	3,24,000
Less: Cost of investment		(10,00,000)	
Goodwill		2,44,000	

Illustration 5

Variety Ltd. holds 46% of the paid-up share capital of VR Ltd. The shares were acquired at a market price of Rs. 17 per share. The balance of shares of VR Ltd. are held by a foreign collaborating company. A memorandum of understanding has been entered into with the foreign company providing for the following:

a. **The shares held by the foreign company will be sold to Variety Ltd. The price per share will be calculated by capitalising the yield at 15%. Yield, for this purpose, would mean 40% of the average of pre-tax profits for the last 3 years, which were Rs. 30 lakhs, Rs. 40 lakhs and Rs. 65 lakhs.**

b. **The actual cost of the shares to the foreign company was Rs. 5,40,000 only. The profit that would accrue to them would be taxable at an average rate of 30%. The tax payable will be deducted from the proceeds and Variety Ltd. will pay it to the Government.**

c. **Out of the net consideration, 50% would be remitted to the foreign company immediately and the balance will be an unsecured loan repayable after two years.**

The above agreement was approved by all concerned for being given effect to on 1.4.20X1. The total assets of VR Ltd. as on 31st March, 20X1 was Rs. 1,00,00,000. It was decided to write down Property, Plant and Equipment by Rs. 1,75,000. Current liabilities of VR Ltd. as on the same date were Rs. 20,00,000. The paid-up share capital of VR Ltd. was Rs. 20,00,000 divided into 2,00,000 equity shares of Rs. 10 each.

Find out goodwill/capital reserve to Variety Ltd. on acquiring wholly the shares of VR Ltd.

Solution

1. Computation of Purchase Consideration

a.	Yield of VR Ltd.: $\left[\frac{40}{100} \times \frac{30+40+65}{3}\right]$	Rs. 18 lakhs
b.	Price per share of VR Ltd.:	
	Capitalized Yield: $\left[\frac{18lakhs}{0.15}\right]$	Rs. 120 lakhs
	No. of shares	2 lakhs
	Therefore, price per share	Rs. 60
c.	Purchase Consideration for 54% shares in VR Ltd.	
	2 lakh shares x 54% x Rs. 60 per shares	Rs. 64.80 lakhs
d.	Discharge of Purchase Consideration:	
	Tax at source (Rs. 64.80 lakhs – Rs. 5.40 lakhs) × $\frac{30}{100}$	Rs.17.82 lakhs
	50% of purchase consideration (net of tax) in cash [Rs. (64.80 – 17.82) x 50%]	Rs. 23.49 lakhs
	Balance – Unsecured Loan	Rs. 23.49 lakhs

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2. Goodwill / Capital Reserve to Variety Ltd.

	Rs. in lakhs	
Total Assets	100.00	
Less: Reduction in Value of Property, Plant and Equipment	(1.75)	
	Rs.98.25	
Less: Current Liabilities	(20.00)	
Net Assets of VR Ltd. on Date of Acquisition		78.25
Purchase Consideration: 54% purchased from Foreign Co.	64.80	
Investment: 46% existing stake	15.64	(80.44)
Goodwill on Date of Acquisition		**2.19**

Illustration 6

A Ltd. acquired 60% shares of B Ltd. @ Rs. 20 per share. Following is the extract of Balance Sheet of B Ltd.:

	Rs.
10,00,000 Equity Shares of Rs. 10 each	1,00,00,000
10% Debentures	10,00,000
Trade Payables	55,00,000
Property, Plant and Equipment	70,00,000
Investments	45,00,000
Current Assets Loans and Advances	22,00,000

On the same day B Ltd. declared dividend at 20% and as agreed between both the companies Property, Plant and Equipment were to be depreciated @ 10% and investment to be taken at market value of Rs. 60,00,000. Calculate the Goodwill or Capital Reserve to be recorded in Consolidated Financial Statements.

Solution

Since dividend is declared by B Ltd. on the date of acquisition itself, it would be out of the divisible profits of B Ltd. existing on the date of acquisition i.e., pre-acquisition profits from the perspective of A Ltd. Accordingly, as per AS 13, such pre-acquisition dividend would be reduced from the cost of investment, as seen below in the determination of Goodwill on the date of acquisition.

	Rs.	Rs.
Assets		
Property, Plant and Equipment	70,00,000	

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Less: Value written off (Rs. 70 lakhs x 10%)	(7,00,000)	
	63,00,000	
Investments at Market Value	60,00,000	
Current Assets	68,00,000	
Loans and Advances	22,00,000	2,13,00,000
Less: Liabilities		
Trade Payables	55,00,000	
10% Debentures	10,00,000	(65,00,000)
Net Assets of B Ltd.		1,48,00,000
Share of A Ltd. in Net Assets of B Ltd.: 60%		88,80,000
Less: Cost of Investment in B Ltd. (60% stake):		
10,00,000 Equity Shares x 60% x Rs. 20 per share	1,20,00,000	
Less: Pre-acquisition dividend: 6,00,000 shares x Rs. 2	(12,00,000)	(1,08,00,000)
Goodwill on Date of Acquisition		**19,20,000**

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Illustration 7

H Ltd. acquired 3,000 shares in S Ltd., at a cost of Rs. 4,80,000 on 31.7.20X1. The capital of S Ltd. consisted of 5,000 shares of Rs. 100 each fully paid. The Profit & Loss Account of this company for 20X1 showed an opening balance of Rs. 1,25,000 and profit for the year was Rs. 3,00,000. At the end of the year, it declared a dividend of 40%. Record the entry in the books of H Ltd., in respect of the dividend. Assume the profit is accruing evenly and calendar year as financial year.

Solution

The profits of S Ltd., have to be divided between capital and revenue profits from the point of view of the holding company:

	Capital Profit (Pre acquisition) Rs.		**Revenue Profit (Post acquisition) Rs.**
Balance on 1.1.20X1	1,25,000	—	
Profit for 20X1 (3,00,000 × 7/12)	1,75,000	(3,00,000×5/12)	1,25,000
Total	3,00,000		1,25,000
Proportionate share of H Ltd. (3/5)	1,80,000		75,000

Total dividend declared = Rs. 5,00,000 X 40 % = Rs. 2,00,000

H Ltd.'s share in the dividend = Rs. 2,00,000 X 3/5 = Rs.1,20,000

There can be two situations as regards the treatment of dividend of Rs.1,20,000:

1. **The profit for 20X1 has been utilised to pay the dividend.**

   The share of H Ltd in profit for the first seven months of S Ltd = Rs.1,05,000 (i.e., Rs.1,75,000 × 3/5)

   Profit for the remaining five months = Rs. 75,000
   (i.e., Rs. 1,25,000 × 3/5).

   The dividend of Rs. 1,20,000 will be adjusted in this ratio of 1,05,000: 75,000 = Rs. 70,000 out of profits up to 31.7.20X1 and Rs. 50,000 out of profits after that date.

   The dividend out of profits subsequent to 31.7.20X1 will be revenue income and that out of earlier profits will be capital receipt. Hence the entry will be:

		Rs.	Rs.
Bank	Dr.	1,20,000	
To Investment Account			70,000
To Profit and Loss Account			50,000

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2. **Later profits have been utilised first and then pre- acquisition profits.**

   In such a case, the whole of Rs. 75,000 (share of H Ltd. in profits of S Ltd., after 31.7.20X1) would be received and treated as revenue income; the remaining dividend, Rs.45,000 (Rs.1,20,000 less Rs. 75,000) would be capital receipt. The entry would be:

		Rs.	Rs.
Bank	Dr.	1,20,000	
To Investment Account			45,000
To Profit and Loss Account			75,000

Note: Point (2) discussed above can arise only if there is definite information about the profits utilized. In practice, such treatment is rare.

Illustration 8

A Ltd. and B Ltd. provide the following information:

	Rs. '000s	
	A Ltd.	**B Ltd.**
Equity Shares	6,000	5,000
6% Preference Shares	NIL	1,000
General Reserve	1,200	800
Profit and Loss Account	1,020	1,790
Trade Payables	3,850	3,410
Dividend Payable	600	500
Goodwill	100	20
Property, Plant and Equipment	3,850	2,750
Investment	1,620	1,100
Inventory	1,900	4,150
Trade Receivables	4,600	4,080
Cash & Bank	600	400

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A Ltd. purchased 3/4th interest in B Ltd. at the beginning of the year at the premium of 25%.

Following other information is available:

a. Profit & Loss Account of B Ltd. includes Rs. 1,000 thousands bought forward from the previous year.

b. The General Reserve balance is brought forward from the previous year.

c. The directors of both the companies have declared a dividend of 10% on equity share capital for the previous and current year.

From the above information calculate Pre- and Post-acquisition Profits, Minority Interest and Cost of Control.

Solution

Calculation of Pre- and Post-Acquisition Profits:

	Pre-Acquisition Profits (Rs.)	**Post-Acquisition Profits (Rs.)**
Profit & Loss Account	10,00,000	7,90,000
General Reserve	8,00,000	NIL
	18,00,000	7,90,000

Less: Share of Minority Interest: (¼)	(4,50,000)	(1,97,500)
Attributable to Parent	13,50,000	5,92,500
	(Cost of Control)	(Post-acquisition Profits)

Calculation of Minority Interest:

Particulars	Rs.
Paid-up Equity Share Capital (Rs. 50,00,000 x ¼)	12,50,000
Paid-up Preference Share Capital	10,00,000
Share in Reserves:	
Profit & Loss Account: Rs. 17,90,000 x ¼	4,47,500
General Reserve: Rs. 8,00,000 x ¼	2,00,000
Minority Interest	**28,97,500**

Calculation of Goodwill/Capital Reserve

	Rs.	Rs.
Cost of Investment in Subsidiary:	46,87,500	
Rs. 50,00,000 x 75% x 125% (cost + 25% premium)		
Less: Pre-acquisition dividend	(3,75,000)	43,12,500
Less: Net Worth of B Ltd. on Date of Acquisition (attributable to A Ltd.):		
Paid-up Capital	37,50,000	
Pre-acquisition Reserves	13,50,000	(51,00,000)
Capital Reserve		7,87,500

<u>**Illustration 9**</u>

On 31st March, 20X1, P Ltd. acquired 1,05,000 shares of Q Ltd. for Rs. 12,00,000. The position of Q Ltd. on that date was as under:

	Rs.
Property, plant and equipment	**10,50,000**
Current Assets	**6,45,000**
1,50,000 equity shares of Rs. 10 each fully paid	**15,00,000**

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Pre-incorporation profits	**30,000**
Profit and Loss Account	**60,000**
Trade payables	**1,05,000**

P Ltd. and Q Ltd. give the following information on 31st March, 20X3:

	P Ltd. **Rs.**	**Q Ltd.** **Rs.**
Equity shares of Rs. 10 each fully paid (before bonus issue)	**45,00,000**	**15,00,000**
Securities Premium	**9,00,000**	**–**
Pre-incorporation profits	**–**	**30,000**
General Reserve	**60,00,000**	**19,05,000**
Profit and Loss Account	**15,75,000**	**4,20,000**
Trade payables	**5,55,000**	**2,10,000**
Property, plant and equipment	**79,20,000**	**23,10,000**
Investment: 1,05,000 Equity shares in Q Ltd. at cost	**12,00,000**	**–**
Current Assets	**44,10,000**	**17,55,000**

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Directors of Q Ltd. made bonus issue on 31.3.20X3 in the ratio of one equity share of Rs. 10 each fully paid for every two equity shares held on that date. Bonus shares were issued out of post-acquisition profits by using General Reserve.

Calculate as on 31st March, 20X3 (i) Cost of Control/Capital Reserve; (ii) Minority Interest; (iii) Consolidated Profit and Loss Account in each of the following cases:

a. Before issue of bonus shares;

b. Immediately After issue of bonus shares.

<u>Solution</u>

Shareholding pattern

Particulars	**Number of Shares**	**% of holding**
a. P Ltd.		
i. Purchased on 31.03.20X1	1,05,000	
ii. Bonus Issue (1,05,000/2)	52,500	
Total	1,57,500	70%
b. Minority Interest	67,500	30%

Calculations of (i) Cost of Control/Capital Reserve; (ii) Minority Interest; (iii) Consolidated Profit and Loss Account as on 31st March, 20X3:

a. Before issue of bonus shares

i.	**Cost of control/capital reserve**	**Rs.**	**Rs.**
	Investment in Q Ltd.		12,00,000
	Less: Face value of investments (Share Capital)	10,50,000	
	Capital profits (W.N.)	63,000	(11,13,000)
	Cost of control (i.e., Goodwill)		87,000
ii.	**Minority Interest**		**Rs.**
	Share Capital		4,50,000
	Capital profits (W.N.)		27,000
	Revenue profits (W.N.)		6,79,500
			11,56,500
iii.	**Consolidated profit and loss account – P Ltd.**		**Rs.**
	Balance		15,75,000
	Add: Share in revenue profits of Q Ltd. (W.N.)		15,85,500
			31,60,500

b. Immediately after issue of bonus shares

i.	**Cost of control/capital reserve**	**Rs.**	**Rs.**
	Face value of investments (Rs.10,50,000 + Rs.5,25,000)	15,75,000	
	Capital Profits (W.N.)	63,000	16,38,000
	Less: Investment in Q Ltd.		(12,00,000)
	Capital reserve		4,38,000
ii.	**Minority Interest**		**Rs.**
	Share Capital(Rs.4,50,000 + Rs.2,25,000)		6,75,000
	Capital profits (W.N.)		27,000
	Revenue profits (W.N.)		4,54,500
			11,56,500
iii.	**Consolidated profit and loss account – P Ltd.**		**Rs.**
	Balance		15,75,000
	Add: Share in revenue profits of Q Ltd. (W.N.)		10,60,500
			26,35,500

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Working Note:

Analysis of Profits of Q Ltd.

	Capital Profits (Pre-acquisition) (Before and after issue of bonus shares) Rs.	**Revenue Profits (Post-acquisition)**	
		Before Bonus Issue Rs.	**After Bonus Issue Rs.**
Pre-incorporation profits	30,000		
Profit and loss account on 31.3.20X1	60,000		
	90,000		
General reserve*		19,05,000	19,05,000
Less: Bonus shares			(7,50,000)
			11,55,000
Profit for period of 1st April, 20X1 to 31st March, 20X3 (Rs. 4,20,000 – Rs. 60,000)		3,60,000	3,60,000
		22,65,000	15,15,000
P Ltd.'s share (70%)	63,000	15,85,500	10,60,500
Minority's share (30%)	27,000	6,79,500	4,54,500

*Share of P Ltd. in General reserve has been adjusted in Consolidated Profit and Loss Account.

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Illustration 10

Prepare consolidated balance sheet of H Ltd. and its subsidiary as at 31st March, 20X1 from the following information:

	H Ltd.	**S Ltd.**
	Rs.	**Rs.**
PPE	**5,00,000**	**3,00,000**
Investments		
(20,000 equity shares of S Ltd.)	**2,20,000**	
Current Assets	**1,55,000**	**1,00,000**
Share capital (Fully paid equity shares of Rs. 10 each)	**5,00,000**	**2,50,000**
Profit and loss account	**2,00,000**	**1,00,000**
Trade Payables	**1,75,000**	**50,000**

H Ltd. acquired the shares of S Ltd. on 31st March, 20X1.

Solution

Percentage of holding:

		No. of Shares	Percentage
Holding Co	:	20,000	(80%)
Minority shareholders	:	5,000	(20%)
TOTAL SHARES	:	25,000	

Consolidated Balance Sheet of H Ltd. and its subsidiary S Ltd. as at 31st March, 20X1

		Note No	Amount (Rs.)
	I. EQUITY AND LIABILITIES		
1	**Shareholder's Fund**		
	a. Share Capital	1	5,00,000
	b. Reserve and Surplus	2	2,60,000
2	**Minority interest**	3	
3	**Current Liabilities**		70,000
	a. Trade payables	4	2,25,000
	Total		10,55,000
	II. ASSETS		
1.	**Non-Current Assets**		
	PPE	5	8,00,000
2.	**Current Assets**	6	2,55,000
	Total		10,55,000

Notes to Accounts

		Amounts (Rs.)
1	**Share capital**	
	50,000 Equity Shares @ Rs.10 each	5,00,000
2	**Reserve and Surplus**	
	Capital Reserve (W.N.)	60,000
	Profit and loss account	2,00,000
		2,60,000

3	**Minority Interest**		
	Paid up value of shares	50,000	
	Add: Share in Profit and loss account	20,000	70,000
4	**Trade payables**		
	H Ltd.		1,75,000
	S Ltd.		50,000
			2,25,000
5	**PPE**		
	H Ltd.		5,00,000
	S Ltd.		3,00,000
			8,00,000
6	**Current Assets**		
	H Ltd.		1,55,000
	S Ltd.		1,00,000
			2,55,000

Working Note:

Determination of Goodwill/(Capital Reserve)		**(Rs.)**
Cost of investment		2,20,000
Less: Paid up value of shares (80% of 2,50,000)	2,00,000	
Share in pre-acquisition profits (80% of 1,00,000)	80,000	(2,80,000)
Capital Reserve		(60,000)

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Illustration 11

H Ltd. and S Ltd. provide the following information as at 31st March,20X2:

	H Ltd.	**S Ltd.**
	Rs.	**Rs.**
PPE	**1,00,000**	**1,30,000**
Investments (8,000 equity shares of S Ltd.)	**1,26,000**	
Current Assets	**74,000**	**70,000**
Share capital (Fully paid equity shares of Rs.10 each)	**1,50,000**	**1,00,000**
Profit and loss account	**50,000**	**40,000**
Trade Payables	**1,00,000**	**60,000**

Additional information: H Ltd. acquired the shares of S Ltd. on 1-7-20X1 and Balance of profit and loss account of S Ltd. on 1-4-20X1 was 30,000. Prepare consolidated balance sheet of H Ltd. and its subsidiary as at 31st March, 20X2.

Solution

Percentage of holding:

		No. of shares	Percentage
Holding Co.	:	8,000	(80%)
Minority shareholders	:	2,000	(20%)
Total shares	:	10,000	

Consolidated Balance Sheet of H Ltd. and its subsidiary S Ltd. as at 31st March, 20X2

		Note No	Amount (Rs.)
	I. EQUITY AND LIABILITIES		
1	Shareholder's Fund		
	a. Share Capital	1	1,50,000
	b. Reserve and Surplus	2	56,000
2	**Minority interest**	3	28,000
	Current Liabilities		
	a. Trade payables	4	1,60,000
	Total		**3,94,000**
	II. ASSETS		
1.	**Non-Current Assets**		
	PPE	5	2,30,000
	Intangible Asset	6	20,000
2.	Current Assets	7	1,44,000
	Total		**3,94,000**

Notes to Accounts

			Amounts (Rs.)
1	**Share capital**		1,50,000
	15,000 Equity Shares @ Rs.10 each		
2	**Reserve and Surplus**		
	Profit and loss account (Rs. 50,000+ 80% of 9/12 x 10,000)		56,000
3	**Minority Interest**		
	Share capital (20% of Rs. 1,00,000)	20,000	

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	Share in Profit and loss account (Rs. 40,000 X 20%)	8,000	28,000
4	**Trade payables**		
	H Ltd.		1,00,000
	S Ltd.		60,000
			1,60,000
5	**PPE**		
	H Ltd.		1,00,000
	S Ltd.		1,30,000
			2,30,000
6	Intangible Asset		
	Cost of Investment		1,26,000
	Less: Paid up value of shares (80% of Rs. 1,00,000)		
	Share in pre-acquisition profits		(80,000)
	80% of [30,000+3/12(40,000-30,000)]		(26,000)
	Goodwill		20,000
7	**Current Assets**		
	H Ltd.		74,000
	S Ltd.		70,000
			1,44,000

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Illustration 12

From the Balance Sheets and information given below, prepare Consolidated Balance Sheet of Virat Ltd. and Anushka Ltd. as at 31st March. Virat Ltd. holds 80% of Equity Shares in Anushka Ltd. since its (Anushka Ltd.'s) incorporation.

Balance Sheet of Virat Ltd. and Anushka Ltd. as at 31st March, 20X1

Particulars	Note No.	Virat Ltd. (Rs.)	Anushka Ltd. (Rs.)
I. Equity and Liabilities			
1. Shareholder's Funds			
a. Share Capital	1	6,00,000	4,00,000
b. Reserves and Surplus	2	1,00,000	1,00,000
2. Non-current Liabilities			
Long Term Borrowings		2,00,000	1,00,000

3. Current Liabilities			
a. Trade Payables		1,00,000	1,00,000
Total		**10,00,000**	**7,00,000**
II. Assets			
1. Non-current assets			
a. Property, Plant and Equipment		4,00,000	3,00,000
b. Non-current investments	3	3,20,000	-
2. Current Assets			
a. Inventories		1,60,000	2,00,000
b. Trade Receivables		80,000	1,40,000
c. Cash & Cash Equivalents		40,000	60,000
Total		**10,00,000**	**7,00,000**

Notes to Accounts

	Particulars	(Rs.)	Virat Ltd. (Rs.)	Anushka Ltd. (Rs.)
1.	**Share capital**			
	60,000 equity shares of Rs. 10 each fully paid up		6,00,000	--
	40,000 equity shares of Rs. 10 each fully paid up		--	4,00,000
	Total		6,00,000	4,00,000
2.	**Reserves and Surplus**			
	General Reserve		1,00,000	1,00,000
	Total		1,00,000	1,00,000
3.	**Non-current investments**			
	Shares in Anushka Ltd		3,20,000	--

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Solution

Consolidated balance Sheet of Virat Ltd. and its Subsidiary Anushka Ltd. as at 31st March, 20X1

I.	**EQUITY AND LIABILITIES:**		
1.	**Shareholders' Funds:**		
	a. Share Capital	1	6,00,000
	b. Reserve and Surplus	2	1,80,000
2.	**Minority Interest**	3	1,00,000

3.	**Non-Current Liabilities:**		
	Long Term Borrowings	4	3,00,000
4.	**Current Liabilities:**		
	Trade Payables	5	2,00,000
	Total		**13,80,000**
II.	**ASSETS:**		
1.	**Non-Current Assets**		
	Property, Plant & Equipment	6	7,00,000
2.	**Current Assets:**		
	a. Inventories	7	3,60,000
	b. Trade receivables	8	2,20,000
	c. Cash and Cash Equivalents	9	1,00,000
	Total		**13,80,000**

Notes to Accounts

	Particulars	Rs.	Rs.
1.	**Share capital**		
	60,000 equity shares of Rs.10 each fully paid up		6,00,000
2.	**Reserves and Surplus**		
	General Reserve	1,00,000	
	Add: General reserve of Anushka Ltd (80%)	80,000	
	Total		1,80,000
3.	**Minority interest**		
	20% share in Anushka Ltd (WN 3)		1,00,000
4.	**Long term borrowings**		
	Long term borrowings of Virat	2,00,000	
	Add: Long term borrowings of Anushka	1,00,000	
	Total		3,00,000
5.	**Trade payables**		
	Trade payables of Virat	1,00,000	
	Add: Trade payables of Anushka	1,00,000	
	Total		2,00,000
6.	**Property, Plant and Equipment (PPE)**		
	PPE of Virat Ltd	4,00,000	

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	Add: PPE of Anushka Ltd	3,00,000	
	Total		7,00,000
7.	**Inventories**		
	Inventories of Virat Ltd	1,60,000	
	Add: Inventories of Anushka Ltd	2,00,000	
	Total		3,60,000
8.	**Trade receivables**		
	Trade receivables of Virat Ltd	80,000	
	Add: Trade receivables of Anushka Ltd	1,40,000	
	Total		2,20,000
9.	**Cash and cash equivalents**		
	Cash and cash equivalents of Virat Ltd	40,000	
	Add: Cash and cash equivalents of Anushka Ltd	60,000	
	Total		1,00,000

Working Notes:

1. **Basic Information**

Company Status	Dates	Holding Status
Holding Co. = Virat Ltd. Subsidiary = Anushka Ltd.	Acquisition: Anushka's Incorporation Consolidation: 31st March, 20X1	Holding Company = 80% Minority Interest = 20%

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2. **Analysis of General Reserves of Anushka Ltd**

   Since Virat holds shares in Anushka since its incorporation, the entire Reserve balance of Rs.1,00,000 will be Revenue.

3. **Consolidation of Balances**

Holding - 80%, Minority - 20%	Total	Minority Interest	Holding Company	
Equity Capital	4,00,000	80,000	3,20,000	-
General Reserves	1,00,000	20,000	Nil (pre-acq)	80,000 (post-acq)
Total		1,00,000	3,20,000	80,000
Cost of Investment			(3,20,000)	
Goodwill/capital reserve			NIL	-
Parent's Balance				1,00,000

Amount for Consolidated Balance Sheet				1,80,000

Illustration 13

From the following balance sheets of H Ltd. And its subsidiary S Ltd. drawn up at 31st March, 20X1, prepare a consolidated balance sheet as at that date, having regard to the following:

i. **Reserves and Profit and Loss Account of S Ltd. stood at Rs. 25,000 and Rs. 15,000 respectively on the date of acquisition of its 80% shares by H Ltd. on 1st April, 20X0.**

ii. **Machinery (Book-value Rs. 1,00,000) and Furniture (Book value Rs. 20,000) of S Ltd. were revalued at Rs. 1,50,000 and Rs. 15,000 respectively on 1st April, 20X0 for the purpose of fixing the price of its shares. [Rates of depreciation computed on the basis of useful lives: Machinery 10%, Furniture 15%.]**

Balance Sheet of H Ltd. and S Ltd. as at 31st March, 20X1

Particulars	**Note No.**	**H Ltd. (Rs.)**	**S Ltd. (Rs.)**
I. Equity and Liabilities			
1. Shareholder's Funds			
a. Share Capital	1	6,00,000	1,00,000
b. Reserves and Surplus	2	3,00,000	1,00,000
2. Current Liabilities			
a. Trade Payables		1,50,000	57,000
Total		**10,50,000**	**2,57,000**
II. Assets			
1. Non-current assets			
a. Property, Plant and Equipment	3	4,50,000	1,07,000
b. Other non- current investments	4	6,00,000	1,50,000
Total		**10,50,000**	**2,57,000**

Notes to Accounts

		Rs.	**H Ltd. (Rs.)**	**S Ltd. (Rs.)**
1.	**Share capital**			
	6,000 equity shares of Rs. 100 each, fully paid up		6,00,000	--
	1,000 equity shares of Rs. 100 each, fully paid up		--	1,00,000
	Total		6,00,000	1,00,000

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2.	**Reserves and Surplus**			
	General reserves		2,00,000	75,000
	Profit and loss account			25,000
			1,00,000	
	Total		3,00,000	1,00,000
3.	**Property, Plant and Equipment**			
	Machinery		3,00,000	90,000
	Furniture		1,50,000	17,000
	Total		4,50,000	1,07,000
4.	**Other Non-current investments**			
	Non-current Investments		4,40,000	1,50,000
	Shares in S Ltd.			
	(800 shares at Rs.200 each)		1,60,000	--
	Total		6,00,000	1,50,000

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Solution

Consolidated Balance Sheet of H Ltd. and its Subsidiary S Ltd. as at 31st March, 20X1

Particulars	Note No.	H Ltd. (Rs.)
I. Equity and Liabilities		
1. Shareholder's Funds		
a. Share Capital	1	6,00,000
b. Reserves and Surplus	2	3,44,600
2. Minority Interest	3	48,150
3. Current Liabilities		
a. Trade Payables		2,07,000
Total		**11,99,750**
II. Assets		
1. Non-current assets		
a. Property, Plant and Equipment	4	5,97,750
b. Intangible assets	5	12,000
c. Other non- current investments	6	5,90,000
Total		**11,99,750**

Notes to Accounts

		Rs.		
1.	**Share capital**			
	6,000 equity shares of Rs. 100 each, fully paid up			6,00,000
	Total			6,00,000
2.	**Reserves and Surplus**			
	Reserves		2,00,000	
	Add: 4/5th share of S Ltd.'s post-acquisition reserves (W.N.3)		40,000	2,40,000
	Profit and Loss Account		1,00,000	
	Add: 4/5th share of S Ltd.'s post-acquisition profits (W.N.4)		4,600	1,04,600
	Total			3,44,600
	Minority interest in S Ltd. (W.N.5)			48,150
3.	**Property, plant and equipment**			
4.	Machinery			
	H. Ltd.		3,00,000	
	S Ltd.	1,00,000		
	Add: Appreciation	50,000		
		1,50,000		
	Less: Depreciation (1,50,000 X 10%)*	(15,000)	1,35,000	
	Furniture			
	H. Ltd.		1,50,000	
	S Ltd.	20,000		
	Less: Decrease in value	(5,000)		
		15,000		
	Less: Depreciation (15,000 X 15%)*	(2,250)	12,750	5,97,750
	Intangible assets			
5.	Goodwill [W.N.6]			12,000
	Other non-current investments			
6.	H Ltd.		4,40,000	
	S Ltd.		1,50,000	
	Total			5,90,000

* As an alternative manner of presentation, the solution contains only the 'additional depreciation'.

Working Notes:

	Rs.
1. Pre-acquisition profits and reserves of S Ltd.	
Reserves	25,000
Profit and Loss Account	15,000
	40,000
H Ltd.'s = 4/5 (or 80%) × 40,000	32,000
Minority Interest= 1/5 (or 20%) × 40,000	8,000
2. Profit on revaluation of assets of S Ltd.	
Profit on Machinery Rs. (1,50,000 – 1,00,000)	50,000
Less: Loss on Furniture Rs. (20,000 – 15,000)	5,000
Net Profit on revaluation	45,000
H Ltd.'s share 4/5 × 45,000	36,000
Minority Interest 1/5 × 45,000	9,000
3. Post-acquisition reserves of S Ltd.	
Post-acquisition reserves (Total reserves less pre-acquisition reserves = Rs.75,000 – 25,000)	50,000
H Ltd.'s share 4/5 × 50,000	40,000
Minority interest 1/5 × 50,000	10,000
4. Post -acquisition profits of S Ltd.	
Post-acquisition profits (Profit & loss account balance less pre-acquisition profits = Rs. 25,000 – 15,000)	10,000
Add: Excess depreciation charged on furniture @ 15% on Rs. 5,000 i.e. (20,000 – 15,000)	750
	10,750
Less: Under depreciation on machinery @ 10% on Rs. 50,000 i.e. (1,50,000 – 1,00,000)	(5,000)
Adjusted post-acquisition profits	5,750
H Ltd.'s share 4/5 × 5,750	4,600
Minority Interest 1/5 × 5,750	1,150
5. Minority Interest	
Paid-up value of (1,000 – 800) = 200 shares held by outsiders i.e., 200 × Rs. 100 (or 1,00,000 X 20%)	20,000

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Add: 1/5th share of pre-acquisition profits and reserves	8,000
1/5th share of profit on revaluation	9,000
1/5th share of post-acquisition reserves	10,000
1/5th share of post-acquisition profit	1,150
	48,150
6. Cost of Control or Goodwill	
Price paid by H Ltd. for 800 shares(A)	1,60,000
Intrinsic value of the shares	
Paid-up value of 800 shares held by H Ltd. i.e. 800 × Rs. 100	80,000
(Or 1,00,000 X 80%)	
Add: $4/5^{th}$ share of pre-acquisition profits and reserves	32,000
$4/5^{th}$ share of profit on the revaluation	36,000
Intrinsic value of shares on the date of acquisition (B)	1,48,000
Cost of control or Goodwill (A – B)	12,000

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Illustration 14

a. **A Ltd. holds 80% of the equity capital and voting power in B Ltd. A Ltd. sells inventories costing Rs. 180 lacs to B Ltd at a price of Rs. 200 lacs. The entire inventories remain unsold with B Ltd. at the financial year end i.e. 31 March 20X1.**

b. **A Ltd. holds 75% of the equity capital and voting power in B Ltd. A Ltd. purchases inventories costing Rs. 150 lacs from B Ltd at a price of Rs. 200 lacs. The entire inventories remain unsold with A Ltd. at the financial year end i.e. 31 March 20X1. Suggest the accounting treatment for the above mentioned transactions in the consolidated financial statements of A Ltd. giving reference of the relevant guidance/standard.**

Solution

As per para 16 and 17 of AS 21, intragroup balances and intragroup transactions and resulting unrealized profits should be eliminated in full. Unrealized losses resulting from intragroup transactions should also be eliminated unless cost cannot be recovered.

Intragroup balances and intragroup transactions, including sales, expenses and dividends, are eliminated in full. Unrealized profits resulting from intragroup transactions that are included in the carrying amount of assets, such as inventory and fixed assets, are eliminated in full. Unrealized losses resulting from intragroup transactions that are deducted in arriving at the carrying amount of assets are also eliminated unless cost cannot be recovered.

One also needs to see whether the intragroup transaction is “upstream” or “down-stream”.

Upstream transaction is a transaction in which the subsidiary company sells goods to holding

company. While in the downstream transaction, holding company is the seller and subsidiary company is the buyer.

In the case of upstream transaction, since the goods are sold by the subsidiary to holding company; profit is made by the subsidiary company, which is ultimately shared by the holding company and the minority shareholders. In such a transaction, if some goods remain unsold at the balance sheet date, the unrealized profit on such goods should be eliminated from minority interest as well as from consolidated profit on the basis of their share-holding besides deducting the same from unsold inventory.

But in the case of downstream transaction, the whole profit is earned by the holding company, therefore, whole unrealized profit should be adjusted from unsold inventory and consolidated profit and loss account only irrespective of the percentage of the shares held by the parent.

Using above mentioned guidance, following adjustments would be required:

a. This would be the case of downstream transaction. In the consolidated profit and loss account for the year ended 31 March 20X1, entire transaction of sale and purchase of Rs. 200 lacs each, would be eliminated by reducing both sales and purchases (cost of sales).

Further, the unrealized profits of Rs. 20 lacs (i.e. Rs. 200 lacs – Rs. 180 lacs), would be eliminated from the consolidated financial statements for financial year ended 31 March 20X1, by reducing the consolidated profits/ increasing the consolidated losses, and reducing the value of closing inventories as of 31 March 20X1.

b. This would be the case of upstream transaction. In the consolidated profit and loss account for the year ended 31 March 20X1, entire transaction of sale and purchase of Rs. 200 lacs each, would be eliminated by reducing both sales and purchases (cost of sales).

Further, the unrealized profits of Rs. 50 lacs (i.e. Rs. 200 lacs – Rs. 150 lacs), would be eliminated in the consolidated financial statements for financial year ended 31 March 20X1, by reducing the value of closing inventories by Rs. 50 lacs as of 31 March 20X1. In the consolidated balance sheet as of 31 March 20X1, A Ltd.'s share of profit from B Ltd will be reduced by Rs. 37.50 lacs (being 75% of Rs. 50 lacs) and the minority's share of the profits of B Ltd would be reduced by Rs. 12.50 lacs (being 25% of Rs. 50 lacs).

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Illustration 15

H Ltd and its subsidiary S Ltd provide the following information for the year ended 31st March, 20X3:

	H Ltd. (Rs. in lacs)	S Ltd. (Rs. in lacs)
Sales and other income	5,000	1,000
Increase in Inventory (closing less opening)	1,000	200
Raw material consumed	800	200
Wages and Salaries	800	150
Production expenses	200	100
Administrative Expenses	200	100
Selling and Distribution Expenses	200	50
Interest	100	50
Depreciation	100	50

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Other Information:

H Ltd. sold goods to S Ltd. of Rs. 120 lacs at cost plus 20%. Inventory of S Ltd. includes such goods valuing Rs. 24 lacs. Administrative expenses of S Ltd. include Rs. 5 lacs paid to H Ltd. as consultancy fees. Selling and distribution expenses of H Ltd. include Rs. 10 lacs paid to S Ltd. as commission.

H Ltd. holds 80% of equity share capital of Rs. 1,000 lacs in S Ltd. prior to 20X1-20X2. H Ltd. took credit to its Profit and Loss Account, the proportionate amount of dividend declared and paid by S Ltd. for the year 20X1-20X2.

Prepare a consolidated statement of profit and loss...

Solution

Consolidated statement of profit and loss of H Ltd. and its subsidiary S Ltd. for the year ended on 31st March, 20X3

Particulars	Note No.	Rs. in Lacs
I. Revenue from operations	1	5,865
II. Total Income		**5,865**
III. Expenses		
Cost of material purchased/consumed	2	1,180
Changes of inventories of finished goods	3	(1,196)
Employee benefit expense	4	950

Finance cost	5	150
Depreciation and amortization expense	6	150
Other expenses	7	535
Total expenses		**1,769**
IV. Profit before tax (II-III)		**4,096**

Notes to Accounts

		Rs. in Lacs	**Rs. in Lacs**
1.	Revenue from operations		
	Sales and other income		
	H Ltd.	5,000	
	S Ltd.	1,000	
		6,000	
	Less: Inter-company sales	(120)	
	Consultancy fees received by H Ltd. from S Ltd.	(5)	
	Commission received by S Ltd. from H Ltd.	(10)	5,865
2.	Cost of material purchased/consumed		
	H Ltd.	800	
	S Ltd.	200	
		1,000	
	Less: Purchases by S Ltd. from H Ltd.	(120)	880
	Direct expenses (Production)		
	H Ltd.	200	
	S Ltd.	100	300
			1,180
3.	Changes of inventories of finished goods		
	H Ltd.	1,000	
	S Ltd.	200	
	Less: Unrealized profits $24 \text{ lacs} \times \frac{20}{120}$	(4)	1,196
4.	Employee benefits and expenses		
	Wages and salaries:		
	H Ltd.	800	
	S Ltd.	150	950

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5.	Finance cost		
	Interest:		
	H Ltd.	100	
	S Ltd.	50	150
6.	Depreciation		
	H Ltd.	100	
	S Ltd.	50	150
7.	Other expenses		
	Administrative expenses		
	H Ltd.	200	
	S Ltd.	100	
	Less: Consultancy fees received by H Ltd. from S Ltd.	(5)	295
	Selling and distribution Expenses:		
	H Ltd.	200	
	S Ltd.	50	
	Less: Commission received by S Ltd. from H Ltd.	(10)	240
			535

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Illustration 16

Subsidiary B Ltd. provides the following balance sheet:

Particulars	**Note No.**	**20X0 (Rs.)**	**20X1 (Rs.)**
I. Equity and Liabilities			
1. Shareholder's Funds			
a. Share Capital	1	5,00,000	5,00,000
b. Reserves and Surplus	2	2,86,000	7,14,000
2. Current Liabilities			
a. Short term borrowings	3	--	1,70,000
b. Trade Payables		4,90,000	4,94,000
c. Short-term provisions	4	3,10,000	4,30,000
Total		15,86,000	23,08,000

II. Assets			
1. Non-current assets			
a. Property, Plant and Equipment	5	2,72,000	2,24,000
b. Non-current Investment			4,00,000
2. Current assets			
a. Inventories		5,97,000	7,42,000
b. Trade Receivables		5,94,000	8,91,000
c. Cash & Cash Equivalents		51,000	3,000
d. Other current assets	6	72,000	48,000
Total		15,86,000	23,08,000

		20X0 (Rs.)	20X1 (Rs.)
1.	**Share capital**		
	5,000 equity shares of Rs.10 each, fully paid up	5,00,000	5,00,000
2.	**Reserves and Surplus**		
	General Reserves	2,86,000	7,14,000
3.	**Short term borrowings**		
	Bank overdraft	--	1,70,000
4.	**Short term provisions**		
	Provision for taxation	3,10,000	4,30,000
5.	**Property, plant and equipment**		
	Cost	3,20,000	3,20,000
	Less: Depreciation	(48,000)	(96,000)
	Total	2,72,000	2,24,000
6.	**Other current Assets**		
	Prepaid expenses	72,000	48,000

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Also consider the following information:

a. **B Ltd. is a subsidiary of A Ltd. Both the companies follow calendar year as the accounting year.**

b. **A Ltd. values inventory on weighted average basis while B Ltd. used FIFO basis. To bring B Ltd.'s values in line with those of A Ltd, its value of inventory is required to be reduced by Rs.12,000 at the end of 20X0 and Rs. 34,000 at the end of 20X1.**

c. **B Ltd. deducts 1% from Trade Receivables as a general provision against doubtful debts.**

d. **Prepaid expenses in B Ltd. include advertising expenditure carried forward of Rs. 60,000 in 20X0 and Rs. 30,000 in 20X1, being part of initial advertising expenditure of Rs. 90,000 in 20X0 which is being written off over three years. Similar amount of advertising expenditure of A Ltd. has been fully written off in 20X0.**

Restate the balance sheet of B Ltd. as at 31st December, 20X1 after considering the above information, for the purpose of consolidation. Would restatement be necessary to make the accounting policies adopted by A Ltd. and B Ltd. uniform.

Solution

As per para 20 and 21 of AS 21, Consolidated financial statements:

Consolidated financial statements should be prepared using uniform accounting policies for like transactions and other events in similar circumstances. If it is not practicable to use uniform accounting policies in preparing the consolidated financial statements, that fact should be disclosed together with the proportions of the items in the consolidated financial statements to which the different accounting policies have been applied.

If a member of the group uses accounting policies other than those adopted in the consolidated financial statements for like transactions and events in similar circumstances, appropriate adjustments are made to its financial statements when they are used in preparing the consolidated financial statements.

Accordingly in the given case, restatement would be required to make the accounting policies of A Ltd and B Ltd uniform.

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Adjusted reserves of B Ltd.:

	Rs.	**Rs.**
Reserves as given		7,14,000
Add: Provision for doubtful debts		
{[8,91,000 / 99 X 100]-8,91,000}		9,000
		7,23,000
Less: Reduction in value of Inventory	34,000	
Advertising expenditure to be written off	30,000	(64,000)
Adjusted reserves		6,59,000

Note: No adjustment would be required in respect of opening inventory of B Ltd as that will not have any impact on P&L.

Restated Balance Sheet of B Ltd. as at 31st December, 20X1

Particulars	Note No.	20X0 (Rs.)
I. Equity and Liabilities		
1. Shareholder's Funds		
a. Share Capital	1	5,00,000
b. Reserves and Surplus	2	6,59,000
2. Current Liabilities		
a. Short term borrowings	3	1,70,000
b. Trade Payables		4,94,000
c. Short-term provisions	4	4,30,000
Total		22,53,000
II. Assets		
1. Non-current assets		
a. Property, Plant and Equipment	5	2,24,000
b. Non-current Investment		4,00,000
2. Current assets		
a. Inventories	6	7,08,000
b. Trade Receivables	7	9,00,000
c. Cash & Cash Equivalents		3,000
d. Other current assets	8	18,000
Total		22,53,000

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Notes to Accounts

			20X1 (Rs.)
1.	**Share capital**		
	5,000 equity shares of Rs.10 each, fully paid up		5,00,000
2.	**Reserves and Surplus**		
	General Reserves (refer to WN)		6,59,000
3.	**Short term borrowings**		
	Bank overdraft		1,70,000
4.	**Short term provisions**		
	Provision for taxation		4,30,000

5.	**Property, plant and equipment**		
	Cost		3,20,000
	Less: Depreciation		(96,000)
	Total		2,24,000
6.	**Inventory**		
	Actual inventory		7,42,000
	Less: Change in method of valuation		(34,000)
	Total		7,08,000
7.	**Trade receivables**		
	Actual trade receivables		8,91,000
	Add: Adjustment for provision		9,000
	Total		9,00,000
8.	**Other current Assets**		
	Prepaid expenses		48,000

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TEST YOUR KNOWLEDGE

MCQs

1. **Minority interest should be presented in the consolidated balance sheet**
   a. **As a part of liabilities.**
   b. **As a part of equity of the parent's shareholders.**
   c. **Separately from liabilities and the equity of the parent's shareholders.**
   d. **As a part of assets.**

2. **Minority of the subsidiary is entitled to**
   a. **Capital profits of the subsidiary company.**
   b. **Revenue profits of the subsidiary company.**
   c. **Both capital and revenue profits of the subsidiary company.**
   d. **Neither capital nor revenue profits of the subsidiary.**

3. **In consolidation of accounts of holding and subsidiary company _________ is eliminated in full.**
   a. **Current liabilities of subsidiary company.**
   b. **Reserves and surplus of both holding and subsidiary company.**
   c. **Mutual indebtedness.**
   d. **Nothing.**

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4. **In consolidated balance sheet, the share of the outsiders in the net assets of the subsidiary must be shown as**
   a. **Minority interest.**
   b. **Capital reserve.**
   c. **Current liability.**
   d. **Current assets.**

5. **Provision for Tax made by the subsidiary company will appear in the consolidated balance sheet as an item of**
   a. **Current liability.**
   b. **Revenue profit.**
   c. **Capital profit.**
   d. **Current assets.**

ANSWERS/SOLUTION

MCQs

1.	**c.**	Separately from liabilities and the equity of the parent's shareholders.
2.	**c.**	Both capital and revenue profits of the subsidiary company.
3.	**c.**	Mutual indebtedness.
4.	**a.**	Minority interest.
5.	**a.**	Current liability.

PRACTICAL QUESTIONS

Q.NO.1. Hemant Ltd. purchased 80% shares of Power Ltd. on 1st January, 20X1 for Rs.2,10,000. The issued capital of Power Ltd., on 1st January, 20X1 was Rs.1,50,000 and the balance in the Profit & Loss Account was Rs.90,000. During the year ended 31st December, 20X1, Power Ltd. earned a profit of Rs.30,000 and at year end, declared and paid a dividend of Rs. 22,500. What is the amount of minority interest as on 1st January, 20X1 and 31st December, 20X1? Also compute goodwill/ capital reserve at the date of acquisition.

SOLUTION

Total dividend paid is Rs. 22,500 (out of post-acquisition profits), hence dividend received by Hemant will be credited to P & L account. Hemant Ltd.'s share of dividend = Rs. 22,500 X 80% = Rs. 18,000

Goodwill on consolidation (at the date of acquisition):	**Rs.**	**Rs.**
Cost of shares		2,10,000
Less: Face value of capital i.e. 80% of capital	1,20,000	
Add: Share of capital profits [90,000 X 80 %]	72,000	(1,92,000)
Goodwill		18,000
Minority interest on:		
- **1st January, 20X1:**		
20% of Rs. 2,40,000 [1,50,000 + 90,000]		48,000
- **31st December, 20X1:**		
20% of Rs. 2,47,500 [1,50,000 + 90,000 + 30,000 – 22,500]		49,500

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Q.NO.2. **King Ltd. acquires 70% of equity shares of Queen Ltd. as on 31st March, 20X1 at a cost of Rs. 140 lakhs. The following information is available from the balance sheet of Queen Ltd. as on 31st March, 20X1:**

	Rs. in lakhs
Property, plant and equipment	**240**
Investments	**110**
Current Assets	**140**
Loans & Advances	**30**
15%Debentures	**180**
Current Liabilities	**100**

The following revaluations have been agreed upon (not included in the above figures):

Property, plant and equipment- up by 20% and Investments- down by 10%.

King Ltd. purchased the shares of Queen Ltd. @ Rs.20 per share (Face value - Rs.10).

Calculate the amount of goodwill/capital reserve on acquisition of shares of Queen Ltd.

SOLUTION

SHRESHTA

Revalued net assets of Queen Ltd. as on 31st March, 20X1

	Rs. in lakhs	**Rs. in lakhs**
PPE [240 X 120%]		288
Investments [110 X 90%]		99
Current Assets		140
Loans and Advances		30
Total Assets after revaluation		557
Less: 15% Debentures	180.0	
Current Liabilities	100.0	(280)
Equity / Net Worth		277
King Ltd.'s share of net assets (70% of 277)		193.9
King Ltd.'s cost of acquisition of shares of Queen Ltd. (Rs.140 lakhs)		(140)
Capital reserve		53.9

Q.NO.3. From the following information, determine Minority Interest on the date of acquisition and on the date of consolidation in each case:

Case	Subsidiary Company	% of Share owned	Cost	Date of Acquisition 01-01-20X1		Consolidation date 31-12-20X1	
				Share Capital Rs.	Profit and Loss A/c Rs.	Share Capital Rs.	Profit and Loss A/c Rs.
Case-A	X	90%	2,00,000	1,50,000	75,000	1,50,000	85,000
Case-B	Y	75%	1,75,000	1,40,000	60,000	1,40,000	20,000
Case-C	Z	70%	98,000	40,000	20,000	40,000	20,000
Case-D	M	95%	75,000	60,000	35,000	60,000	55,000

SOLUTION

Minority Interest = Equity attributable to minorities

Equity is the residual interest in the assets of an enterprise after deducting all its liabilities i.e., in this case, it should be equal to Share Capital + Profit & Loss A/c

A = Share capital on 1.1.20X1

B = Profit & loss account balance on 1.1.20X1

C = Share capital on 31.12.20X1

D = Profit & loss account balance on 31.12.20X1

	Minority % Shares Owned [E]	Minority interest as at the date of acquisition [E] x [A + B] Rs.	Minority interest as at the date of consolidation [E] X [C + D] Rs.
Case A [100-90]	10 %	22,500	23,500
Case B [100-75]	25 %	50,000	40,000
Case C [100-70]	30 %	18,000	18,000
Case D [100-95]	5%	4,750	5,750

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Q.NO.4. **A Ltd acquired 1,600 ordinary shares of Rs.100 each of B Ltd on 1st July, 20X1.**

On 31st December, 20X1, the balance sheets of the two companies were as given below:

Balance Sheet of A Ltd. and its subsidiary, B Ltd. as at 31st December, 20X1

Particulars	Note No.	A Ltd. (Rs.)	B Ltd. (Rs.)
I. Equity and Liabilities			
1. Shareholder's Funds			
a. Share Capital	1	5,00,000	2,00,000
b. Reserves and Surplus	2	2,97,200	1,82,000
2. Current Liabilities			
a. Trade Payables		47,100	17,400
b. Short-term borrowings	3	80,000	
Total		9,24,300	3,99,400
II. Assets			
1. Non-current assets			
a. Property, Plant and Equipment		3,90,000	3,15,000
b. Non-current Investment	4	3,40,000	--
2. Current assets	5		
a. Inventories		1,20,000	36,400
b. Trade Receivables		59,800	40,000
c. Cash & Cash Equivalents	6	14,500	8,000
Total		9,24,300	3,99,400

Notes to Accounts

		A Ltd. Rs.	B Ltd. Rs.
1.	Share capital		
	5,000 equity shares of Rs.10 each, fully paid up	5,00,000	-
	2,000 shares of Rs. 100 each, fully paid up	-	2,00,000
	Total	5,00,000	2,00,000
2.	Reserves and Surplus		
	General Reserves	2,40,000	1,00,000
	Profit & loss	57,200	82,000
	Total	2,97,200	1,82,000
3.	Short term borrowings		
	Bank overdraft	80,000	--

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4.	Property, plant and equipment		
	Land and building	1,50,000	1,80,000
	Plant & Machinery	2,40,000	1,35,000
	Total	3,90,000	3,15,000
5.	Non-current Investments		
	Investment in B Ltd (at cost)	3,40,000	--
6.	Cash & Cash equivalents		
	Cash	14,500	8,000

The Profit & Loss Account of B Ltd. showed a credit balance of Rs.30,000 on 1st January, 20X1 out of which a dividend of 10% was paid on 1st August, 20X1; A Ltd. credited the dividend received to its Profit & Loss Account. The Plant & Machinery which stood at Rs.1,50,000 on 1st January, 20X1 was considered as worth Rs. 1,80,000 on 1st July, 20X1; this figure is to be considered while consolidating the Balance Sheets. The rate of depreciation on plant & machinery is 10% (computed on the basis of useful lives).

Prepare consolidated Balance Sheet as at 31st December, 20X1

SHRESHTA

SOLUTION

Consolidated Balance Sheet of A Ltd. and its subsidiary, B Ltd.

as at 31st December, 20X1

Particulars	Note No.	20X0 (Rs.)
I. Equity and Liabilities		
1. Shareholder's Funds		
a. Share Capital	1	5,00,000
b. Reserves and Surplus	2	3,08,800
2. Minority Interest		83,600
3. Current Liabilities		
a. Trade Payables	3	64,500
b. Short-term provisions	4	80,000
Total		10,36,900
II. Assets		
1. Non-current assets		
a. Property, Plant and Equipment	5	7,41,000
b. Intangible assets	6	17,200

2. **Current assets**		
a. Inventories	7	1,56,400
b. Trade Receivables	8	99,800
c. Cash & Cash Equivalents	9	22,500
Total		10,36,900

Notes to Accounts

				20X1 (Rs.)
1.	**Share capital**			
	5,000 equity shares of Rs.100 each			5,00,000
2.	**Reserves and Surplus**			
	Reserves		2,40,000	
	Profit & loss (Refer to W.N 8)		68,800	
	Total			3,08,800
3.	**Trade Payables**			
	A Ltd.	47,100		
	Add: B Ltd	17,400		
	Total			64,500
4.	**Short term borrowings**			
	Bank overdraft			80,000
5.	**Property, plant and equipment**			
	Land and building- A Ltd	1,50,000		
	Add: Land and building- B Ltd	1,80,000	3,30,000	
	Plant & Machinery (Refer to W.N 7)		4,11,000	
	Total			7,41,000
6.	**Intangible assets**			
	Goodwill (refer to W.N 6)			17,200
7.	**Inventories**			
	A Ltd.		1,20,000	
	B Ltd.		36,400	
	Total			1,56,400

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8.	**Trade Receivables**			
	A Ltd.	59,800		
	B Ltd.	40,000		99,800
	Total			
9.	**Cash & Cash equivalents**			
	Cash of A Ltd		14,500	
	Add: cash of B Ltd.			
	Total		8,000	22,500

Share holding Pattern

Total Shares of B Ltd 2,000 shares

Shares held by A Ltd 1,600 shares i.e. 80 %

Minority Shareholding 400 shares i.e. 20 %

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Working Notes:

1. The dividend @ 10% on 1,600 shares - Rs. 16,000 received by A Ltd. should have been credited to the investment A/c, being out of pre-acquisition profits. A Ltd., must pass a rectification entry, viz.

   Profit & Loss Account Dr. Rs. 16,000

   To Investment Rs. 16,000

2. The Plant & Machinery of B Ltd. would stand in the books at Rs. 1,42,500 on 1st July, 20X1, considering only six months' depreciation on Rs. 1,50,000 total depreciation being Rs. 15,000. The value put on the assets being Rs. 1,80,000, there is an appreciation to the extent of Rs. 37,500 (1,80,000 – 1,42,500).

3. **Capital profits of B Ltd.**

	Rs.	Rs.
Reserve on 1st January, 20X1 (Assumed there is no movement in reserves during the year and hence balance as on 1st January 20X1 is same as of 31st December 20X1)		1,00,000
Profit & Loss Account Balance on 1st January, 20X1	30,000	

Less: Dividend paid	(20,000)	10,000
Profit for 20X1:		
Total Rs. 82,000		
Less: Rs.10,000		
Rs. 72,000		
Proportionate up to 1st July, 20X1 on time basis		
(Rs. 72,000/2)		36,000
Appreciation in value of Plant & Machinery		37,500
		1,83,500
Less: 20% due to outsiders		(36,700)
Holding company's share		**1,46,800**

4. **Revenue profits of B Ltd.:**

Profit after 1st July, 20X1 [(82,000 – 10,000) x ½]		36,000
Less: Depreciation		
10% depreciation on Rs.1,80,000 for 6 months	9,000	
Less: Depreciation already charged for 2nd half year on 1,50,000	(7,500)	(1,500)
		34,500
Less: 1/5 due to outsiders		(6,900)
Share of A Ltd.		**27,600**

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5. **Minority interest:**

Par value of 400 shares (2,00,000 X 20%)	40,000
Add: 1/5Capital Profits [WN 3]	36,700
1/5 Revenue Profits [WN 4]	6,900
	83,600

6. **Cost of Control:**

Amount paid for 1,600 shares	3,40,000	
Less: Dividend out of pre-acquisition profits	(16,000)	3,24,000
Par value of shares	1,60,000	
Capital Profits –share of A Ltd. [WN 3]	1,46,800	(3,06,800)
Cost of Control or Goodwill		17,200

7. **Value of plant & Machinery:**

		2,40,000
B Ltd.	1,35,000	
Add: Appreciation on 1st July, 20X1 [1,80,000 – (1,50,000 – 7,500)]	37,500	
	1,72,500	
Add: Deprecation for 2nd half charged on pre-revalued value	7,500	
Less: Depreciation on Rs.1,80,000 for 6 months	(9,000)	1,71,000
		4,11,000

8. **Profit & Loss Account (Consolidated):**

A Ltd. as given	57,200	
Less: Dividend transferred to Investment A/c	(16,000)	41,200
Share of A Ltd. in revenue profits of B Ltd. (WN 4)		27,600
		68,800

Q.NO.5. On 31st March, 20X1, the Balance Sheets of H Ltd. and its subsidiary S Ltd. stood as follows:

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Balance Sheet of H Ltd. and its subsidiary S Ltd. as at 31st March, 20X1

Particulars	Note No.	H Ltd. (Rs. in Lacs)	S Ltd. (Rs. in Lacs)
I. Equity and Liabilities			
1. Shareholder's Funds			
a. Share Capital	**1**	**12,000**	**4,800**
b. Reserves and Surplus	**2**	**5,499**	**3,000**
2. Current Liabilities			
a. Trade payables	**3**	**1,833**	**1,014**
b. Short term provisions	**4**	**855**	**394**
c. Other current liabilities (Dividend payable)		**1,200**	**-**
Total		**21,387**	**9,208**
II. Assets			
1. Non-current assets	**5**		
Property, Plant and Equipment		**9,468**	**5,486**
Non-current Investments		**3,000**	
(Shares in S Ltd.)			

2. **Current assets**			
a. **Inventories**	**6**	**3,949**	**1,956**
b. **Trade receivables**		**2,960**	**1,562**
c. **Cash and cash equivalents**	**7**	**1,490**	**204**
d. **Short term loans and advances**		**520**	
Total		**21,387**	**9,208**

Notes to Accounts

		H Ltd. (Rs. in lacs)	**S Ltd. (Rs. in lacs)**
1.	**Share Capital**		
	Authorized share capital	15,000	6,000
	Equity shares of Rs. 10 each, fully paid up		
	Issued and Subscribed:		
	Equity shares of Rs. 10 each, fully paid up	12,000	4,800
2.	**Reserves and surplus**		
	General Reserve	2,784	1,380
	Profit and Loss Account:	2,715	1,620
	Total	5,499	3,000
3.	**Trade Payables**		
	Creditors	1,461	854
	Bills Payable	372	160
		1,833	1,014
4.	**Short term provisions**		
	Provision for Taxation	855	394
5.	**Property, plant and equipment**		
	Land and Buildings	2,718	–
	Plant and Machinery	4,905	4,900
	Furniture and Fittings	1,845	586
	Total	9,468	5,486
6.	**Trade receivables**		
	Debtors	2,600	1,363
	Bills Receivable	360	199
	Total	2,960	1,562
7.	**Short term loans and advances**		
	Sundry Advances	520	--

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The following information is also provided to you:

a. **H Ltd. purchased 180 lakh shares in S Ltd. on 31st March, 20X0 when the balances of General Reserve and Profit and Loss Account of S Ltd. stood at Rs. 3,000 lakh and Rs. 1,200 lakh respectively.**
b. **On 1st April, 20X0, S Ltd. declared a dividend @ 20% for the year ended 31st March, 20X0. H Ltd. credited the dividend received by it to its Profit and Loss Account.**
c. **On 1st January, 20X1, S Ltd. issued 3 fully paid-up bonus shares for every 5 shares held out of balances of its general reserve as on 31st March, 20X0.**
d. **On 31st March, 20X1, all the bills payable in S Ltd.'s balance sheet were acceptances in favour of H Ltd. But on that date, H Ltd. held only Rs. 45 lakh of these acceptances in hand, the rest having been endorsed in favour of its trade payables.**
e. **On 31st March, 20X1, S Ltd.'s inventory included goods which it had purchased for Rs. 100 lakh from H Ltd. which made a profit @ 25% on cost.**

Prepare a Consolidated Balance Sheet of H Ltd. and its subsidiary S Ltd. as at 31st March, 20X1

<u>SOLUTION</u>

Consolidated Balance Sheet of H Ltd. and its subsidiary S Ltd. as at 31st March, 20X1

Particulars	**Note No.**	**(Rs. in Lacs)**
I. Equity and Liabilities		
1. Shareholder's Funds		
a. Share Capital	1	12,000
b. Reserves and Surplus	2	7,159
2. Minority Interest [W.N.6]		3,120
3. Current Liabilities		
a. Trade payables	3	2,802
b. Short term provisions	4	1,249
c. Other current liabilities	5	1,200
Total		27,530
II. Assets		
1. Non-current assets		
Property, Plant and Equipment	6	14,954
2. Current assets		
a. Inventories	7	5,885

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b. Trade receivables	8	4,477
c. Short term loans and advances	9	520
d. Cash and cash equivalents	10	1,694
Total		27,530

Notes to Accounts

					(Rs. in lacs)	(Rs. in lacs)
1.	**Share Capital**					
	Authorized share capital					15,000
	Equity shares of Rs. 10 each, fully paid up					
	Issued and Subscribed:					
	Equity shares of Rs. 10 each, fully paid up					12,000
	Total					12,000
2.	**Reserves and surplus**					
	Capital Reserve (Note 5)				1,320	
	General Reserve (2,784 + 108)				2,892	
	Profit and Loss Account:					
	H Ltd.			2,715		
	Less: Dividend wrongly credited	360				
	Unrealized Profit	20		(380)		
				2,335		
	Add: Share in S Ltd.'s Revenue profits			612	2,947	
	Total					7,159
3.	**Trade payables**					
	Creditors					
	H Ltd.		1,461			
	S Ltd.		854		2,315	
	Bills Payable					
	H Ltd.		Rs.372			
	S Ltd.		Rs.160			
			Rs.532			
	Less: Mutual owing		Rs.(45)		487	2,802

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4.	**Short term provisions**		
	Provision for Taxation		
	H Ltd.	855	
	S Ltd.	394	
	Total		1,249
5.	**Other current liabilities**		
	Dividend payable		
	H Ltd.		1,200
6.	**Property, plant and equipment**		
	Land and Buildings		
	H Ltd.	2,718	
	Plant and Machinery		
	H Ltd. Rs.4,905		
	S Ltd. Rs.4,900	9,805	
	Furniture and Fittings		
	H Ltd. Rs.1,845		
	S Ltd. Rs. 586	2,431	
	Total		14,954
7.	**Inventories**		
	Stock		
	H Ltd.	3,949	
	S Ltd.	1,956	
		5,905	
	Less: Unrealized profit	(20)	5,885
8.	**Trade receivables**		
	Debtors		
	H Ltd. Rs.2,600		
	S Ltd. Rs.1,363	3,963	
	Bills Receivable		
	H Ltd. Rs.360		
	S Ltd. Rs.199		
	Rs. 559		

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	Less: Mutual Owing	Rs. (45)	514	4,477
9.	**Short term loans and advances**			
	Sundry Advances			520
10.	**Cash and cash equivalents**			
	Cash and Bank Balances			1,694

Share holding pattern of S Ltd.

Shares as on 31st March, 20X1 (Includes bonus shares issued on 1st January, 20X1)	480 lakh shares (4,800 lakhs/ Rs. 10)
H Ltd.'s holding as on 1st April, 20X0	180 lakhs
Add: Bonus received on 1st January, 20X1	108 lakhs (180 / 5 × 3)
Total H Ltd.'s holding as on 31st March, 20X1	288 lakhs i.e. 60 % [288/480 × 100]
Minority Shareholding	40%

Working Notes:

1. S Ltd.'s General Reserve Account

	Rs. in lakhs		Rs. in lakhs
To Bonus to equity shareholders (WN-8)	1,800	By Balance b/d	3,000
		By Profit and Loss A/c	180
To Balance c/d	1,380	(Balancing figure)	______
	3,180		3,180

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2. S Ltd.'s Profit and Loss Account

	Rs. in lakhs		Rs. in lakhs
To General Reserve		By Balance b/d	1,200
[W.N.1]	180	By Net Profit for the year*	1,200
To Dividend paid		(Balancing figure)	
(20% on Rs.3,000 lakhs)	600		
To Balance c/d 2,400	1,620		_____
	2,400		2,400

*Out of Rs. 1,200 lakhs profit for the year, Rs. 180 lakhs has been transferred to reserves.

3. Distribution of Revenue profits

	Rs. in lakhs
Revenue profits (W. N. 2)	1,200

Less: Share of H Ltd. 60%	(720)
(General Reserve Rs. 108 + Profit and Loss Account Rs. 612)	-
Share of Minority Shareholders (40%)	480

Note: The question can also be solved by taking Rs. 1,020 lakhs as post acquisition Profit and Loss balance and Rs. 180 lakhs as post acquisition General Reserve balance. The final answer will be same.

4. **Calculation of Capital Profits**

	Rs. in lakhs
General Reserve on the date of acquisition less bonus shares (Rs. 3,000 – Rs. 1,800)	1,200
Profit and loss account on the date of acquisition less dividend paid (Rs. 1,200 – Rs. 600)	600
	1,800

H Ltd.'s share = 60% of Rs. 1,800 lakhs = Rs. 1,080 lakhs

Minority interest = Rs. 1,800 – Rs. 1,080 = Rs. 720 lakhs

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5. **Calculation of capital reserve**

	Rs. in lakhs
Paid up value of shares held (60% of Rs.4,800)	2,880
Add: Share in capital profits [WN 4]	1,080
	3,960
Less: Cost of shares less dividend received (Rs. 3,000 – Rs. 360)	(2,640)
Capital reserve	1,320

6. **Calculation of Minority Interest**

	Rs. in lakhs
40% of share capital (40% of Rs. 4,800)	1,920
Add: Share in revenue profits [WN 3]	480
Share in capital profits [WN 4]	720
	3,120

7. Unrealized profit in respect of inventory

$$\text{Rs.}100\text{ lakhs} \times \frac{25}{125} = \text{Rs.}20\text{lakhs}$$

8. Computation of bonus to equity shareholders

	Rs. In lakhs
Shares as on 31 March 20X1 including bonus share issued on 1 January 20X1	4,800
Or we can say these are 1 + $\frac{3}{5}$ or $\frac{8}{5}$	
i.e., Shares before bonus issue should have been $\frac{4,800}{8/5}$ =	3,000
Accordingly, bonus issue would be (4,800 - 3,000)	1,800

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UNIT 2: ACCOUNTING STANDARD 23: ACCOUNTING FOR INVESTMENTS IN ASSOCIATES IN CONSOLIDATED FINANCIAL STATEMENTS

LEARNING OUTCOMES

After studying this unit, you will be able to:

- Define the terms 'Associates', 'Significant influence', 'Control', 'Equity method' and other related terms used in the standard.
- Examine the circumstances under which the Equity Method is used.
- Apply the Equity Method in the accounting of investments in the associates.
- Disclose the contingences in the consolidated financial statements.
- Comply with other disclosure requirements as stated in the standard.'

New Inclusion in New syllabus

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2.1 INTRODUCTION

AS 23, came into effect in respect of accounting periods commenced on or after 1-4-2002. AS 23 describes the principles and procedures for recognizing investments in associates (in which the investor has significant influence, but not a subsidiary or joint venture of investor) in the consolidated financial statements of the investor. An investor which presents consolidated financial statements should account for investments in associates as per equity method in accordance with this standard but in its separate financial statements, AS 13 will be applicable.

2.2 OBJECTIVE

The objective of this Standard is to lay down principles and procedures for recognizing the investments in associates and its effect on the financial operations of the group in the consolidated financial statements. Reference to AS 23 is compulsory for the companies following AS 21 and preparing consolidated financial statement for their group. For disclosing investment in associates in the separate financial statement of the investor itself, one should follow AS 13.

2.3 DEFINITIONS OF THE TERMS USED IN THE ACCOUNTING STANDARD

1. A **subsidiary** is an enterprise that is controlled by another enterprise (known as the parent).
2. A **parent** is an enterprise that has one or more subsidiaries.
3. A **group** is a parent and all its subsidiaries.

4. The equity method is a method of accounting whereby the investment is initially recorded at cost, identifying any goodwill/capital reserve arising at the time of acquisition. The carrying amount of the investment is adjusted thereafter for the post acquisition change in the investor's share of net assets of the investee. The consolidated statement of profit and loss reflects the investor's share of the results of the operations of the investee.
5. **Equity** is the residual interest in the assets of an enterprise after deducting all its liabilities.
6. **Consolidated financial statements** are the financial statements of a group presented as those of a single enterprise.
7. **An associate** is an enterprise in which the investor has significant influence and which is neither a subsidiary nor a joint venture of the investor.
8. **Significant influence** is the power to participate in the financial and/or operating policy decisions of the investee but not control over those policies.

This definition excludes the subsidiaries or joint venture from the scope of an associate but apart from these any other enterprises, which are significantly influenced by the investor, is an associate for the purpose of this standard. Any enterprise having 20% or more of the voting power or any interest directly or indirectly in any other enterprise will be assumed to have significantly influence the other enterprise unless proved otherwise. Significant influence may be gained by share ownership, statute or agreement. Similarly any enterprise that does not have 20% or more control then it is assumed not having significant influence on the enterprise unless proved otherwise.

An enterprise can influence the significant economic decision making by many ways like:

- Having some voting power.
- Representation on the board of directors or governing body of the investee.
- Participation in policy-making processes.

Material transactions between the investor and the investee (Influencing intercompany transactions i.e. sale of goods and services, sharing technical knowledge etc.

- Interchange of managerial personnel.
- Provision of essential technical information.

As a general rule, significant influence is presumed to exist when an investor holds, directly or indirectly through subsidiaries, 20% or more of the voting power of the investee.

As with the classification of any investment, the substance of the arrangement in each case should be considered. If it can be clearly demonstrated that an investor holding 20% or more of the voting power of the investee does not have significant influence, the investment will not be accounted for as an associate.

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A substantial or majority ownership by another investor does not necessarily preclude an investor from having significant influence.

If the investor holds, directly or indirectly through subsidiaries, less than 20% of the voting power of the investee, it is presumed that the investor does not have significant influence, unless such influence can be clearly demonstrated. The presence of one or more of the indicators as above may indicate that an investor has significant influence over a less than 20% owned corporate investee.

Control exists when parent company has either:

a. The ownership, directly or indirectly through subsidiary(ies), of more than one-half of the voting power of an enterprise.

b. Or control of the composition of the board of directors in the case of a company or of the composition of the corresponding governing body in case of any other enterprise so as to obtain economic benefits from subsidiary company's activities.

If any company is controlling the composition of governing body of gratuity trust, provident fund trust etc., since the objective is not the economic benefit and therefore it will not be included in consolidated financial statement.

An enterprise is considered to control the composition of the board of directors of a company or governing body in case of an enterprise other than a company, if it has the power, without the consent or concurrence of any other person, to appoint or remove all or a majority of directors of that company or members of the body. An enterprise is deemed to have the power to appoint a director/member, if any of the following conditions is satisfied:

i. A person cannot be appointed as director/member without the exercise in his favour by that enterprise of such a power as aforesaid; or

ii. A person's appointment as director/member follows necessarily from his appointment to a position held by him in that enterprise; or

iii. The director/member is nominated by that enterprise or a subsidiary thereof.

To understand the above definitions let us take few examples:

Example 1

A Ltd. has 70% holding in C Ltd. and B Ltd. also has 28% holding in the same company. So, A Ltd. with the majority holding i.e. more than 50% is the parent company i.e. a holding company. Since B Ltd. holds more than 20% but not more than 50% in C Ltd., C Ltd. will be an associate of B Ltd.

Example 2

A Ltd. is holding 90% share in B Ltd. and 10% shares in C Ltd., and B Ltd. is holding 11%shares in C Ltd. In this case, A Ltd. is parent of B Ltd.

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As far as the relationship between A Ltd. and C Ltd. is concerned; A Ltd. has a total of direct and indirect holding of (10 + 11) 21% in C Ltd., Thus, C Ltd. is an associate of A Ltd. It may however be noted that for consolidated financial statement purposes, the holding will be 19.9% (10% + 90% of 11%),

2.4 ASSOCIATES ACCOUNTED FOR USING THE EQUITY METHOD

The equity method is a method of accounting whereby the investment is initially recorded at cost, identifying any goodwill/capital reserve arising at the time of acquisition. The carrying amount of the investment is adjusted thereafter for the post acquisition change in the investor's share of net assets of the investee. The consolidated statement of profit and loss reflects the investor's share of the results of operations of the investee.

Goodwill/capital reserve arising on the acquisition of an associate by an investor should be included in the carrying amount of investment in the associate but should be disclosed separately.

From the definition, following broad conclusions can be drawn:

a. In CFS, investment is to be recorded at cost.

b. Any surplus or deficit in cost and net asset to be recorded as goodwill or capital reserve.

c. Distributions received from an investee reduce the carrying amount of the investment.

d. Any subsequent change in share in net asset is adjusted in cost of investment and goodwill/capital reserve.

e. Consolidated Profit & Loss shows the investor's share in the results of operations of the investee.

(Refer Illustration 1)

2.5 CIRCUMSTANCES UNDER WHICH EQUITY METHOD IS FOLLOWED

Equity method of accounting is to be followed by all the enterprises having significant influence on their associates except in the following cases:

a. Control is intended to be temporary because the investment is acquired and held exclusively with a view to its subsequent disposal in the near future. The term 'Near Future' is explained with AS 21.

b. Or it operates under severe long-term restrictions, which significantly impair its ability to transfer funds to the investor.

In both the above cases, investment of investor in the share of the investee is treated as investment according to AS 13.

An investor should discontinue the use of the equity method from the date that:

a. It ceases to have significant influence in an associate but retains, either in whole or in part, its investment.

b. The use of the equity method is no longer appropriate because the associate operates under severe long-term restrictions that significantly impair its ability to transfer funds to the investor.

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From the date of discontinuing the use of the equity method, investments in such associates should be accounted for in accordance with AS 13, Accounting for Investments. For this purpose, the carrying amount of the investment at that date should be regarded as cost thereafter. The reasons for not applying the equity method in accounting for investments in an associate should be disclosed in the consolidated financial statements.

2.6 APPLICATION OF THE EQUITY METHOD

- Many of the rules followed under equity method for an associate is similar to consolidated financial statement rules as in case of subsidiary i.e. AS 21.
- Investment in an associate should be recorded as per the equity method from the date when such relation comes in effect.
- Investment in the associate is recorded at cost and any difference in the cost and investor's share in equity on the date of acquisition is shown as goodwill or capital reserve.

Knowledge Pulse – Did you ever think why the method for consolidation is different for subsidiary and associate? Remember to learn subsidiary first and then Associate – We will in class learn the logic behind why equity method is used for associate and not for subsidiary

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Case 1:

A Ltd. holds 22% share of B Ltd. on 1st April of the year and following are the relevant information as available on the date are Cost of Investment Rs.33,000 and Total Equity on the date of acquisition Rs.2,00,000.

A Ltd.'s share in equity (2,00,000 x 22%)	Rs. 44,000
Less: Cost of Investment	Rs. (33,000)
Capital Reserve	Rs. 11,000

Extract of Balance Sheet: ASSETS

Investment in Associate as per AS 23	**Rs.**	**Rs.**
Share of Net Assets as on 1 April	44,000	
Less: Capital reserve	(11,000)	33,000

Case 2:

A Ltd. holds 22% share of B Ltd. on 1st April of the year and following are the relevant information as available on the date are Cost of Investment Rs.55,000 and Total Equity on the date of acquisition Rs.2,00,000.

Cost of Investment	Rs.55,000
Less: A Ltd.'s share in equity (2,00,000 x 22%)	Rs.44,000
Goodwill	Rs.11,000

Extract of Balance Sheet: ASSETS

Investment in Associate as per AS 23	Rs.	Rs.
Share of Net Assets as on 1 April	44,000	
Add: Goodwill	11,000	55,000

- **Step Acquisition in case of an associate:**

  An enterprise having share of profits of more than 50% in other company, they are said to be in Parent-Subsidiary relationship. However, if the share in profits is more than 20% but up to 50% then this relationship is termed as associate relationship. This stake of 20% can be acquired either in one go or in more than one transaction. This share of stake can be increased further say from 25% to 30%. Adjustment should be made with each transaction.

Case 1 Conversion from a passive investor to an associate in the same year:

A Ltd. acquired 10% stake of B Ltd. on April 01 and further 15% on October 01 during the same year.

Other information is as follow:

Cost of Investment for 10% Rs.1,00,000 and for 15% Rs.1,45,000

Net asset on April 01 Rs.8,50,000 and on October 01 Rs.10,00,000.

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Calculations for April 01:

Cost of investment	**Rs.1,00,000**
10% share in net asset	Rs.85,000
Goodwill	Rs.15,000

Calculations for October 01:

15% share in net asset	**Rs.1,50,000**
Cost of investment	Rs.1,45,000
Capital Reserve	Rs.5,000
Total goodwill (15,000 – 5,000)	Rs.10,000

Case 2 - Conversion from a passive investor to an associate in the same year:

A Ltd. acquired 10% stake of B Ltd. on April 01 and further 15% on October 01 of the same year.

Other information is as follow:

Cost of Investment for 10% Rs.1,00,000 and for 15% Rs.1,55,000

Net asset on April 01 Rs.8,50,000 and on October 01 Rs.10,00,000.

Calculations for April 01:

Cost of investment	**Rs.1,00,000**
10% share in net asset	Rs.85,000
Goodwill	Rs.15,000

Calculations for October 01:

Cost of investment	**Rs.1,55,000**
15% share in net asset	Rs.1,50,000
Goodwill	Rs.5,000
Total goodwill (15,000 + 5,000)	Rs.20,000

Case 3 – Further acquisition in an associate in the same year:

A Ltd. acquired 25% stake of B Ltd. on April 01 and further 5% on October 01 of the same year. Other information is as follow:

Cost of Investment for 25% Rs.1,50,000 and for 5% Rs.20,000

Net asset on April 01 Rs.5,00,000.

Profit for the year Rs.90,000 earned in the ratio 2:1 respectively.

Calculations for April 01:

Cost of investment	**Rs.1,00,000**
25% share in net asset	Rs.1,25,000
Goodwill	Rs.25,000

Calculations for October 01:

Profits for the first half (90,000/3) x 2	**Rs.60,000**
Additional share of A Ltd.	5%
Pre-acquisition profits i.e. capital reserve (60,000 x 5%)	Rs.3,000
5% share in net asset	Rs.25,000
Cost of investment	Rs.20,000
Capital Reserve	Rs.5,000
Cost of Investment on April 01	Rs.1,50,000
Less: Goodwill	Rs.25,000
Carrying Amount on April 01	Rs.1,25,000
Add: Additional Share in Net Asset on October 01	Rs.25,000
Add: Capital share of Profits for first half	Rs.3,000
Add: Revenue shares of Profits for first half (60,000 x 25%)	Rs.15,000
Add: Revenue shares of Profits for second half (30,000 x 30%)	Rs.9,000
Total Carrying Amount on March 31	Rs.1,77,000

- If there is any transaction between the Investor Company and investee concern then the unrealised profits on such goods to the extent of investor's share should be eliminated from consolidated financial statement.

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- Any loss on such transactions are not eliminated to the extent that such loss is not recoverable. Otherwise such losses are written off from consolidated financial statement fully.

(Refer Illustration 2)

- If, under the equity method, an investor's share of losses of an associate equals or exceeds the carrying amount of the investment, the investor ordinarily discontinues recognising its share of further losses and the investment is reported at nil value. Additional losses are provided for to the extent that the investor has incurred obligations or made payments on behalf of the associate to satisfy obligations of the associate that the investor has guaranteed or to which the investor is otherwise committed. If the associate subsequently reports profits, the investor resumes including its share of those profits only after its share of the profits equals the share of net losses that have not been recognised.
- As far as possible the reporting date of the financial statements should be same for consolidated financial statement. If practically it is not possible to draw up the financial statements of one or more enterprise to such date and, accordingly, those financial statements are drawn up to reporting dates different from the reporting date of the investor, adjustments should be made for the effects of significant transactions or other events that occur between those dates and the date of the consolidated financial statements.

  In any case, the difference between reporting dates of the concern and consolidated financial statement should not be more than six months.
- Accounting policies followed in the preparation of the financial statements of the investor, investee and consolidated financial statement should be uniform for like transactions and other events in similar circumstances.

  If accounting policies followed by different enterprises in the group are not uniform, then adjustments should be made in the items of the individual financial statements to bring it in line with the accounting policy of the consolidated statement.
- The carrying amount of investment in an associate should be reduced to recognise a decline, other than temporary, in the value of the investment, such reduction being determined and made for each investment individually.

2.7 CONTINGENCIES

In accordance with AS 4, the investor discloses in the consolidated financial statements:

a. Its share of the contingencies and capital commitments of an associate for which it is also contingently liable; and

b. Those contingencies that arise because the investor is severally liable for the liabilities of the associate.

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2.8 WHY IS EQUITY METHOD OF ACCOUNTING ADOPTED FOR INVESTMENT IN ASSOCIATES?

- Investments in associates cannot be treated as a normal investment under AS 13. The intent of investing to such an extent (i.e.; 20% or more but less than 50% of equity) in an associate is an expression of the fact that the investor is not merely interested in the dividend distribution, but also is interested in the participation of decision-making process in the associate.
- Thus, recognition of income on the basis of distributions received may not be an adequate measure of the income earned by an investor on an investment in an associate because the distributions received may bear little relationship to the performance of the associate. As the investor has significant influence over the associate, the investor has a measure of responsibility for the associate's performance and, as a result, the return on its investment. The investor accounts for this stewardship by extending the scope of its consolidated financial statements to include its share of results of such an associate and so provides an analysis of earnings and investment from which more useful ratios can be calculated. As a result, application of the equity method in consolidated financial statements provides more informative reporting of the net assets and net income of the investor.

2.9 DISCLOSURE

- In addition to the disclosures required above, an appropriate listing and description of associates including the proportion of ownership interest and, if different, the proportion of voting power held should be disclosed in the consolidated financial statements.
- Investments in associates accounted for using the equity method should be classified as long-term investments and disclosed separately in the consolidated balance sheet. The investor's share of the profits or losses of such investments should be disclosed separately in the consolidated statement of profit and loss. The investor's share of any extraordinary or prior period items should also be separately disclosed.
- The name(s) of the associate(s) of which reporting date(s) is/are different from that of the financial statements of an investor and the differences in reporting dates should be disclosed in the consolidated financial statements.
- In case an associate uses accounting policies other than those adopted for the consolidated financial statements for like transactions and events in similar circumstances and it is not practicable to make appropriate adjustments to the associate's financial statements, the fact should be disclosed along with a brief description of the differences in the accounting policies.
- If an associate is not accounted for using the equity method the reasons for not doing the same.
- Goodwill/capital reserve arising on the acquisition of an associate by an investor should be disclosed separately though it is included in the carrying amount of the investment.

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2.10 RELEVANT EXPLANATIONS TO AS 23

2.10.1 Treatment of Proposed Dividend in Associates in Consolidated Financial Statements

In case an associate has made a provision for proposed dividend (i.e. dividend declared after the reporting period but it pertains to that reporting year) in its financial statements, the investor's share of the results of operations of the associate should be computed without taking into consideration the proposed dividend.

2.10.2 Consideration of Potential Equity Shares for Determining whether an Investee is an Associate

The potential equity shares of the investee held by the investor should not be taken into account for determining the voting power of the investor.

Reference: The students are advised to refer the full text of AS 23 “Accounting for Investments in Associates in Consolidated Financial Statements” (issued 2001).

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ILLUSTRATIONS

Illustration 1

A Ltd. acquire 45% of B Ltd. shares on April 01, 20X1, the price paid was Rs.15,00,000. Following are the extracts of balance sheet of B Ltd. as of 1 April 20X1:

Paid up Equity Share Capital	**Rs.10,00,000**
Securities Premium	**Rs.1,00,000**
Reserve & Surplus	**Rs.5,00,000**

B Ltd. has reported net profits of Rs.3,00,000 and paid dividends of Rs.1,00,000 for the year ended 31 March 20X2. Calculate the amount at which the investment in B Ltd. should be shown in the consolidated balance sheet of A Ltd. as on March 31, 20X2.

Solution

Calculation of Goodwill/Capital Reserve under Equity Method

Particulars		**Rs.**	**Rs.**
Investment in B Ltd.	(A)		15,00,000
Equity Shares		10,00,000	
Security Premium		1,00,000	
Reserves & Surplus		5,00,000	
Net Assets		16,00,000	
45% of Net Asset	(B)		7,20,000
Goodwill (A-B)			7,80,000

Calculation of Carrying Amount of Investment in the year ended on 31st March, 20X2

Particulars	**Rs.**
Investment in Associate as per AS 23:	
Share of Net Assets on 1 April 20X1	7,20,000
Add: Goodwill	7,80,000
Cost of Investment	15,00,000
Add: Profit during the year (3,00,000 x 45%)	1,35,000
Less: Dividend paid (1,00,000 x 45%)	(45,000)
Carrying Amount of Investment	15,90,000

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Illustration 2

A Ltd. acquired 40% share in B Ltd. on April 01, 20X1 for Rs.10 lacs. On that date B Ltd. had 1,00,000 equity shares of Rs.10 each fully paid and accumulated profits of Rs.2,00,000. During the year 20X1-20X2, B Ltd. suffered a loss of Rs.10,00,000; during 20X2-20X3 loss of Rs.12,50,000 and during 20X3-20X4 again a loss of Rs.5,00,000. Show the extract of consolidated balance sheet of A Ltd. on all the four dates recording the above events.

Solution

Calculation of Goodwill/Capital Reserve under Equity Method

Particulars	Rs.
Equity Shares	10,00,000
Reserves & Surplus	2,00,000
Net Assets	12,00,000
40% share of Net Assets	4,80,000
Less: Cost of Investment	(10,00,000)
Goodwill	5,20,000

Consolidated Balance Sheet (Extract) as on April 01, 20X1: ASSETS

Investment in Associate as per AS 23	Rs.	Rs.
Share of Net Assets as on 1 April	4,80,000	
Add: Goodwill	5,20,000	10,00,000

Calculation of Carrying Amount of Investment as at 31 March 20X2:

Investment in Associate as per AS 23	Rs.
Share of Net Assets as on 1 April,20X1	4,80,000
Add: Goodwill	5,20,000
Cost of Investment	10,00,000
Less: Loss for the year (10,00,000 x 40%)	(4,00,000)
Carrying Amount of Investment	6,00,000

Consolidated Balance Sheet (Extract) as on March 31, 20X2: ASSETS

Investment in Associate as per AS 23	Rs.	Rs.
Share of Net Assets as on 1 April,20X1	4,80,000	
Less: Share of Loss as above	(4,00,000)	
	80,000	
Add: Goodwill	5,20,000	6,00,000

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Calculation of Carrying Amount of Investment as at 31 March 20X3:

Investment in Associate as per AS 23	**Rs.**
Carrying Amount of Investment as on 31 March 20X2	6,00,000
Less: Loss for the year (12,50,000 x 40%)	(5,00,000)
Carrying Amount of Investment	1,00,000

Consolidated Balance Sheet (Extract) as on March 31, 20X3: ASSETS

Investment in Associate as per AS 23	**Rs.**	**Rs.**
Share of Net Assets as on 1 April,20X1	4,80,000	
Less: Share of Loss as above (Rs.4,00,000 + Rs.5,00,000)	(4,20,000)	
Add: Goodwill		1,00,000

Calculation of Carrying Amount of Investment as at 31 March 20X4:

Investment in Associate as per AS 23	**Rs.**
Carrying Amount of Investment Less: Loss for the year (5,00,000 x 40%=2,00,000, restricted to Carrying amount of Investment in B Ltd.) -refer note below Carrying Amount of Investment	1,00,000

Consolidated Balance Sheet (Extract) as on March 31, 20X4: ASSETS

Investment in Associate as per AS 23	**Rs.**
Investment in B Ltd.	-

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TEST YOUR KNOWLEDGE

MCQs

1. **Identity which of the statements are correct.**

   An enterprise can influence the significant economic decision making by many ways like:

   i. **Representation on the board of directors or governing body of the investee.**

   ii. **Participation in policy-making processes.**

   iii. **Interchange of managerial personnel.**

   iv. **Provision of essential technical information.**

   a. **Statement i. and ii. are correct.**

   b. **Statement i., ii. and iii. are correct.**

   c. **Statement i., ii., iii. and iv. are correct.**

   d. **Statement ii. and iii. are correct.**

2. **A Ltd. is holding 90% share in B Ltd. and 10% shares in C Ltd., and B Ltd. is holding 11% shares in C Ltd. Identity which of the statements are incorrect.**

   i. **In this case, A Ltd. is parent of B Ltd.**

   ii. **As far as the relationship between A Ltd. and C Ltd. is concerned; A Ltd. has a total of direct and indirect holding of (10% + 90% of 11%) 19.9 % in C Ltd.**

   iii. **C Ltd. is an associate of A Ltd.**

   a. **Statement ii. is incorrect.**

   b. **Statement iii. is incorrect.**

   c. **Statement ii. and iii. both are incorrect.**

   d. **All statements are incorrect.**

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3. **A Ltd. acquired 10% stake of B Ltd. on April 01 and further 15% on October 01 of the same year. Other information is as follows:**

   Cost of Investment for 10% Rs.1,00,000 and for 15% Rs.1,55,000

   Net asset on April 01 Rs.8,50,000 and on October 01 Rs.10,00,000.

   What is the amount of goodwill or capital reserve arising on significant influence?

   a. **Goodwill = Rs.10,000.**

   b. **Goodwill = Rs.20,000.**

   c. **Capital Reserve = Rs.10,000.**

   d. **Capital Reserve = Rs.20,000.**

4. A Ltd. acquired 10% stake of B Ltd. on April 01 and further 15% on October 01 during the same year. Other information is as follow:

Cost of Investment for 10% Rs.1,00,000 and for 15% Rs.1,45,000

Net asset on April 01 Rs.8,50,000 and on October 01 Rs.10,00,000.

What is the amount of goodwill or capital reserve arising on significant influence?

a. Goodwill = Rs.10,000.

b. Goodwill = Rs.20,000.

c. Capital Reserve = Rs.10,000.

d. Capital Reserve = Rs.20,000.

5. Identity which of the statements are correct.

i. In case an associate has made a provision for proposed dividend (i.e. dividend declared after the reporting period but it pertains to that reporting year) in its financial statements, the investor's share of the results of operations of the associate should be computed without taking into consideration the proposed dividend.

ii. In case an associate has made a provision for proposed dividend (i.e. dividend declared after the reporting period but it pertains to that reporting year) in its financial statements, the investor's share of the results of operations of the associate should be computed after taking into consideration the proposed dividend.

iii. The potential equity shares of the investee held by the investor should not be taken into account for determining the voting power of the investor.

iv. The potential equity shares of the investee held by the investor should be taken into account for determining the voting power of the investor.

a. Statement i. and iii.

b. Statement ii. and iv.

c. Statement i. only.

d. Statement iii. only

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ANSWERS/SOLUTION

MCQs

1.	**c.**	Statement i., ii., iii. and iv. are correct.
2.	**a.**	Statement ii. is incorrect.
3.	**b.**	Goodwill = Rs.20,000.
4.	**a.**	Goodwill = Rs.10,000.
5.	**a.**	Statement i. and iii.

THEORY QUESTIONS

Q.NO.1. Describe the cases when AS 23 does not allow the use of equity method of accounting?

ANSWER

Equity method of accounting is to be followed by all the enterprises having significant influence on their associates except in the following cases:

a. Control is intended to be temporary because the investment is acquired and held exclusively with a view to its subsequent disposal in the near future.

The term 'Near Future' is explained with AS 21.

Or;

b. It operates under severe long-term restrictions, which significantly impair its ability to transfer funds to the investor.

In both the above cases, investment of investor in the share of the investee is treated as investment according to AS 13.

Q.NO.2. When is an investor required to discontinue the use of the equity method of accounting?

ANSWER

An investor should discontinue the use of the equity method from the date that:

a. It ceases to have significant influence in an associate but retains, either in whole or in part, its investment.

b. The use of the equity method is no longer appropriate because the associate operates under severe long-term restrictions that significantly impair its ability to transfer funds to the investor.

From the date of discontinuing the use of the equity method, investments in such associates should be accounted for in accordance with AS 13, Accounting for Investments. For this purpose, the carrying amount of the investment at that date should be regarded as cost thereafter.

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PRACTICAL QUESTIONS

Q.NO.1. Bright Ltd. acquired 30% of East India Ltd. shares for Rs.2,00,000 on 01-06-20X1. By such an acquisition Bright can exercise significant influence over East India Ltd. During the financial year ending on 31-03-20X1 East India earned profits Rs.80,000 and declared a dividend of Rs.50,000 on 12-08-20X1. East India reported earnings of Rs.3,00,000 for the financial year ending on 31-03-20X2 (assume profits to accrue evenly) and declared dividends of Rs.60,000 on 12-06-20X2.

Calculate the carrying amount of investment in:

i. Separate financial statements of Bright Ltd. as on 31-03-20X2;

ii. Consolidated financial statements of Bright Ltd.; as on 31-03-20X2;

iii. What will be the carrying amount as on 30-06-20X2 in consolidated financial statements?

SOLUTION

i. Carrying amount of investment in Separate Financial Statement of Bright Ltd. as on 31.03.20X2

	Rs.
Amount paid for investment in Associate (on 1.06.20X1)	2,00,000
Less: Pre-acquisition dividend (Rs.50,000 x 30%)	(15,000)
Carrying amount as on 31.3.20X2 as per AS 13	1,85,000

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ii. Carrying amount of investment in Consolidated Financial Statements∗ of Bright Ltd. as on 31.3.20X2 as per AS 23

	Rs.
Carrying amount as per separate financial statements	1,85,000
Add: Proportionate share of 10-month profit of investee as per equity method	
(30% of Rs.3,00,000 x 10/12)	75,000
Carrying amount as on 31.3.20X2	2,60,000

iii. Carrying amount of investment in Consolidated Financial Statement of Bright Ltd. as on 30.6.20X2 as per AS 23

	Rs.
Carrying amount as on 31.3.20X2	2,60,000
Less: Dividend received (Rs.60,000 x 30%)	(18,000)
Carrying amount as on 30.6.20X2	2,42,000

Q.NO.2. A Ltd. acquired 25% of shares in B Ltd. as on 31.3.20X1 for Rs.3 lakhs. The Balance Sheet of B Ltd. as on 31.3.20X1 is given below:

	Rs.
Share Capital	5,00,000
Reserves and Surplus	5,00,000
	10,00,000
Fixed Assets	5,00,000
Investments	2,00,000
II. Current Assets	3,00,000
	10,00,000

During the year ended 31.3.20X2 the following are the additional information available:

i. A Ltd. received dividend from B Ltd., for the year ended 31.3.20X1 at 40% from the Reserves.

ii. B Ltd., made a profit after tax of Rs.7 lakhs for the year ended 31.3.20X2.

iii. B Ltd., declared a dividend @ 50% for the year ended 31.3.20X2 on 30.4.20X2.

A Ltd. is preparing Consolidated Financial Statements in accordance with AS 21 for its various subsidiaries. Calculate:

i. Goodwill if any on acquisition of B Ltd.'s shares.

ii. How A Ltd., will reflect the value of investment in B Ltd., in the Consolidated Financial Statements?

iii. How the dividend received from B Ltd. will be shown in the Consolidated Financial Statements?

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SOLUTION

In terms of AS 23, B Ltd. will be considered as an associate company of A Ltd. as shares acquired represent to more than 20%.

i. Calculation of Goodwill **(Rs.in lakhs)**

Amount paid towards acquisition of stake in B Ltd.	3.00
Less: Pre-acquisition dividend (Rs.5,00,000 x 40% x 25%)	0.50
Cost of Investment in B Ltd.	2.50
Less: Share in the value of Equity of B Ltd. as at the date of investment [25% of Rs.10 lakhs (Rs.5 lakhs + Rs.5 lakhs)]	(2.50)
Goodwill	NIL

ii. **A Ltd.**

Consolidated Profit and Loss Account for the year ended 31st March, 20X2 (An extract)

		Rs.in lakhs
Other income:		
Share of profits in B Ltd.		1.75
Pre-acquisition Dividend received from		
B Ltd.	0.50	
Transfer to investment A/c	(0.50)	Nil

iii. **A Ltd.**

Consolidated Balance Sheet as on 31.3.20X2 (An extract)

		Rs.in lakhs
Non-current investments		
Investment in B Ltd.		
Cost of Investment in B Ltd.	2.50	
Share of profit for year 20X1 – 20X2	1.75	
	4.25	
Add: Goodwill	NIL	4.25

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Working Notes:

1. Pre-acquisition dividend received from B Ltd. amounting to Rs.0.50 lakhs will be reduced from investment value in the books of A Ltd.
2. B Ltd. made a profit of Rs.7 lakhs for the year ended 31st March, 20X2. A Ltd.'s share in the profits of Rs.7 lakhs is Rs.1.75 lakhs.

   Investment in B Ltd. will be increased by Rs.1.75 lakhs and consolidated profit and loss account of A Ltd. will be credited with Rs.1.75 lakhs in the consolidated financial statement of A Ltd.
3. Dividend declared on 30th April, 20X2 will not be recognized in the consolidated financial statement of A Ltd.

UNIT 3: ACCOUNTING STANDARD 27: FINANCIAL REPORTING OF INTERESTS IN JOINT VENTURES

LEARNING OUTCOMES

After studying this unit, you will be able to:

- Define 'Joint venture' 'joint Control', 'control', 'venturer' and investor.
- Appreciate different forms of joint venture
- Examine the contractual arrangements which will differentiate the control as of Associate or Joint venture
- Evaluate the nitty-gritty of different forms of Joint ventures and differentiate among them
- Present the separate and consolidated financial statements of the venturers
- Accounting for transactions between the venturer and Joint venture
- Comply with the disclosure requirements as stated in the standard.

New Inclusion in New Syllabus

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3.1 INTRODUCTION

You would have come across many examples where 2 or more entities would have worked together to achieve a certain purpose. Hindustan Unilever Ltd (HUL), Tata Starbucks Ltd, Tata SIA Airlines Ltd. (Vistara), etc. are a few popular examples of Joint Ventures. Entities enter into such arrangements considering sharing of risk and expense, collaboration of know-how and skill-set, while also impacted by different work-cultures and management style. Depending on the contractual arrangement, the accounting and reporting for Joint Ventures is done.

AS 27, came into effect in respect of accounting periods commenced on or after 01.04.2002.This standard set out principles and procedures for accounting of interests in joint venture and reporting of joint venture assets, liabilities, income and expenses in the financial statements of venturers and investors regardless of the structures or forms under which the joint venture activities take place.

The standard deals with three broad types of joint ventures –

1. Jointly controlled operations,
2. Jointly controlled assets and
3. Jointly controlled entities.

The requirements relating to accounting for joint ventures in consolidated financial statements according to proportionate consolidation method, as contained in AS 27, apply only when consolidated financial statements are prepared by venture. Similarly existence of a contractual

arrangement distinguishes interests which involve joint control from investments in associates in which the investor has significant influence (see Accounting Standard (AS) 23, Accounting for Investments in Associates in Consolidated Financial Statements). An investor in joint venture, which does not have joint control, should report its interest in a joint venture in its consolidated financial statements in accordance with AS 13, AS 21 and AS 23.

3.2 SCOPE

This Standard should be applied in accounting for interests in joint ventures and the reporting of joint venture assets, liabilities, income and expenses in the financial statements of venturers and investors, regardless of the structures or forms under which the joint venture activities take place. The provisions of this AS need to be referred to for consolidated financial statement only when CFS is prepared and presented by the venturer.

3.3 DEFINITIONS

1. **A joint venture** is a contractual arrangement whereby two or more parties undertake an economic activity, which is subject to joint control.

   From the above definition we conclude that the essential conditions for any business relation to qualify as joint venture are:

   - **Two or more parties coming together:** Parties can be an individual or any form of business organization say, BOI, AOP, Company, firm.
   - **Venturers undertake some economic activity:** Economic activity means activities with the profit-making motive. Joint venture is separate from the regular identity of the venturers, it may be in the form of independent and separate legal organization other than regular concern of the venturer engaged in the economic activity.
   - **Venturers have joint control on the economic activity:** The operating and financial decisions are influenced by the venturers and they also share the results of the economic activity.
   - **There exists a contractual agreement:** The relationship between venturers is governed by the contractual agreement. This agreement can be in the form of written and signed agreement or as minutes of venturer meeting or in any other written form.
2. **Joint control** is the contractually agreed sharing of control over an economic activity.
3. **Control** is the power to govern the financial and operating policies of an economic activity so as to obtain benefits from it.
4. A **venturer** is a party to a joint venture and has joint control over that joint venture.
5. An **investor** in a joint venture is a party to a joint venture and does not have joint control over that joint venture.

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6. Proportionate consolidation is a method of accounting and reporting whereby a venturer's share of each of the assets, liabilities, income and expenses of a jointly controlled entity is reported as separate line items in the venturer's financial statements.

3.4 CONTRACTUAL ARRANGEMENT

The joint venture covered under this statement is governed on the basis of contractual agreement. Non-existence of contractual agreement will disqualify an organization to be covered in AS 27. Joint ventures with contractual agreement will be excluded from the scope of AS 27 only if the investment qualifies as subsidiary under AS 21, in this case, it will be covered by AS 21. Contractual agreement can be in the form of written contract, minutes of discussion between parties (venturers), articles of the concern or by-laws of the relevant joint venture. Irrespective of the form of the contract, the content of the contract ideally should include the following points:

- The activity, duration and reporting obligations of the joint venture.
- The appointment of the board of directors or equivalent governing body of the joint venture and the voting rights of the venturers.
- Capital contributions by the venturers.
- The sharing by the venturers of the output, income, expenses or results of the joint venture.

The main object of contractual agreement is to distribute the economic control among the venturers, it ensures that no venturer should have unilateral control. The arrangement identifies those decisions in areas essential to the goals of the joint venture which require the consent of all the venturers and those decisions which may require the consent of a specified majority of the venturers. If contractual agreement is signed by a party to safeguard its right, such agreement will not make the party a venturer.

The contractual arrangement may identify one venturer as the operator or manager of the joint venture. The operator does not control the joint venture but acts within the financial and operating policies which have been agreed to by the venturers in accordance with the contractual arrangement and delegated to the operator

Example 1

IDBI gave loan to the joint venture entity of L&T and Tantia Construction, they signed an agreement according to which IDBI will be informed for all important decisions of the joint venture entity. This agreement is to protect the right of the IDBI, hence just signing the contractual agreement will not make investor a venturer.

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Example 2

X Ltd invested Rs.200 crore as initial capital along with Y Ltd and Z Ltd in GFH Ltd. The purpose of X Ltd making this investment is to grow the business of GFH Ltd along with the other investors. All investors have a right to attend to the meetings and to take decisions with respect to the business of GFH Ltd. All investors are actively involved in running the business of GFH Ltd and have a share in the returns generated by GFH Ltd in an agreed proportion.

GFH Ltd is an example of a Joint Venture and X Ltd, Y Ltd and Z Ltd are all Venturers.

Similarly, just because contractual agreement has assigned the role of a manager to any of the venturer will not disqualify him as venturer.

Example 3

Mr. A, M/s. B & Co. and C Ltd. entered into a joint venture, where according to the agreement, all the policies making decisions on financial and operating activities will be taken in a regular meeting attended by them or their representatives. Implementation and execution of these policies will be the responsibility of Mr. A. Here Mr. A is acting as venturer as well as manager of the concern.

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3.5 FORMS OF JOINT VENTURES

Joint ventures may take many forms and structures, this Statement identifies them in three broad types –

- **Jointly Controlled Operations (JCO),**
- **Jointly Controlled Assets (JCA) and**
- **Jointly Controlled Entities (JCE).**

Any structure which satisfies the following characteristics can be classified as joint ventures:

a. Two or more venturers are bound by a contractual arrangement and

b. The contractual arrangement establishes joint control.

3.6 JOINTLY CONTROLLED OPERATIONS (JCO)

Under this set up, venturers do not create a separate entity for their joint venture business but they use their own resources for the purpose. They raise any funds required for joint venture on their own, they incur any expenses and sales are also realised individually. They use same set of assets and employees for joint venture business and their own business. The joint venture agreement usually provides means by which the revenue from the jointly controlled operations and any expenses incurred in common are shared among the venturers.

Since there is no separate legal entity and venturers don't recognize the transactions separately, they <u>do not maintain a separate set of books for joint venture</u>. All the transactions of joint venture are recorded in their books only.

Following are the key features of JCO:

a. Each venturer has his own separate business.

b. There is no separate entity for joint venture business.

c. All venturers are creating their own assets and maintain them.

d. Each venturer record only his own transactions without any separate set of books maintained for the joint venture business.

e. There is a common agreement between all of them.

f. Venturers use their assets for the joint venture business.

g. Venturers met the liabilities created by them for the joint venture business.

h. Venturers met the expenses of the joint venture business from their funds.

i. Any revenue generated or income earned from the joint venture is shared by the venturers as per the contract.

Since the jointly controlled operation is not purchasing assets or raising finance in its own right, the <u>assets and liabilities used in the activities of the joint venture are those of the ventures</u>. As such, they are accounted for in the financial statements of the venture to which they belong. The only accounting issue that arises is that the output from the project is to be <u>shared among the venturers</u> and, therefore, there must be some mechanism for specifying the allocation of the proceeds and the sharing of any joint expenses.

In respect of its interests in jointly controlled operations, a venturer should recognise in its separate financial statements and consequently in its consolidated financial statements:

a. the assets that it controls and the liabilities that it incurs; and

b. the expenses that it incurs and its share of the income that it earns from the joint venture.

Separate accounting records may not be required for the joint venture itself and financial statements may not be prepared for the joint venture. However, the venturers may prepare accounts for internal management reporting purposes so that they may assess the performance of the joint venture.

Example 4

Mr. A (dealer in tiles and marbles), Mr. B (dealer in various building materials) and Mr. C (Promoter) enters into a joint venture business, where any contract for construction received will be completed jointly, say, Mr. A will supply all tiles and marbles, Mr. B will supply other materials from his godown and Mr. C will look after the completion of construction. As per the contractual agreement, they will

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share any profit/loss in a predetermined ratio. None of them are using separate staff or other resources for the joint venture business and neither do they maintain a separate account. Everything is recorded in their personal business only.

Venturer doesn't maintain a separate set of books but they record only their own transactions of the joint venture business in their books. Any transaction of joint venture recorded separately is only for internal reporting purpose. Once all transactions recorded in venturer financial statement, they don't need to be adjusted for in consolidated financial adjustment.

(Refer Illustration 1)

3.7 JOINTLY CONTROLLED ASSETS (JCA)

Separate legal entity is not created in this form of joint venture but venturer owns the assets jointly, which are used by them for the purpose of generating economic benefit to each of them. They take up any expenses and liabilities related to the joint assets as per the contract. We can conclude the following points:

- There is no separate legal identity.
- There is a common control over the joint assets.
- Venturers use this asset to derive some economic benefit to themselves.
- Each venturer incurs separate expenses for their transactions.
- Expenses on jointly held assets are shared by the venturers as per the contract.
- In their financial statement, venturer shows only their share of the asset and total income earned by them along with total expenses incurred by them.
- Since the assets, liabilities, income and expenses are already recognised in the separate financial statements of the venturer and consequently in its consolidated financial statements, no adjustments or other consolidation procedures are required in respect of these items when the venturer presents consolidated financial statements.
- Financial statements may not be prepared for the joint venture, although the venturers may prepare accounts for internal management reporting purposes so that they may assess the performance of the joint venture.

Example 5

ABC Ltd., BP Ltd. and HP Ltd. having the same point of oil refinery and same place of customers agreed to spread a pipeline from their unit to customers place jointly. They agreed to share the expenditure on the pipeline construction and maintenance in the ratio 3:3:4 respectively and the time allotted to use the pipeline was in the ratio 4:3:3 respectively.

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For the joint venture, each venturer will record his share of joint assets as **classified according to the nature of the assets rather than as an investment** and any expenditure incurred or revenue generated will be recorded with other items similar to JCO.

Following are the few differences between JCO and JCA for better understanding:

- In JCO, venturers use their own assets for joint venture business but in JCA they jointly own the assets to be used in joint venture.
- JCO is an agreement to joint carry on the operations to earn income whereas, JCA is an agreement to jointly construct and maintain an asset to generate revenue to each venturer.
- Under JCO all expenses and revenues are shared at an agreed ratio, in JCA only expenses on joint assets are shared at the agreed ratio.

(Refer Illustration 2)

3.8 JOINTLY CONTROLLED ENTITIES (JCE)

This is the format where venturer creates a new entity for their joint venture business. A jointly controlled entity is a joint venture which involves the establishment of a corporation, partnership or other entity in which each venturer has an interest. The entity operates in the same way as other enterprises, except that a contractual arrangement between the venturers establishes joint control over the economic activity of the entity. All the venturers pool their resources under new banner and this entity purchases its own assets, create its own liabilities, expenses are incurred by the entity itself and sales are also made by this entity. The net result of the entity is shared by the venturers in the ratio agreed upon in the contractual agreement. This contractual agreement also determines the joint control of the venturer. Each venturer usually contributes cash or other resources to the jointly controlled entity. These contributions are included in the accounting records of the venturer and are recognised in its separate financial statements as an investment in the jointly controlled entity.

A jointly controlled entity maintains its own accounting records and prepares and presents financial statements in the same way as other enterprises in conformity with the requirements applicable to that jointly controlled entity

Example

A Ltd and B Ltd are two infrastructure companies operating in City A. The local authority has issued a tender to construct a metro stretch for Rs. 2,000 crore and had invited bidders to apply for the tender. A Ltd and B Ltd, jointly form a new entity AB Ltd that bids for the tender. All machinery and equipment will be the responsibility of A Ltd. All funding will be managed and controlled by B Ltd. Revenue and operating expenses will be shared jointly by A Ltd and B Ltd in the proportion of 60:40. In the above example AB Ltd constitutes a Jointly Controlled Entity (JCE).

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Example (Jointly Controlled Entity (JCE))

Three separate aerospace companies form a separate entity, Aero Ltd, to jointly manufacture an aircraft. They carry responsibility for different areas of expertise, such as: manufacturing engines; manufacturing fuselage and wings; and aerodynamics.

The companies carry out different parts of the manufacturing process, each using its own resources and expertise in order to manufacture, market and distribute the aircraft jointly. The three entities share the revenues from the sale of aircraft and jointly incur expenses.

The revenues and common costs are shared, as agreed in the consortium contract. Parties also incur their own separate costs, such as labour costs, manufacturing costs, supplies, inventory of unused parts and work in progress. Each party recognises its separately incurred costs in full.

Aero Ltd maintains separate accounting records. The consortium agreement comprises the following:

Aero Ltd will invoice the customers on the investors' behalf. The allocation of revenue from the aircraft's sale is in proportion to the investors' interests.

All administrative costs incurred by Aero Ltd are shared by the parties in proportion to their interests; Aero Ltd will recharge these, with no additional margin.

The companies carry out different parts of the manufacturing process, each using its own resources and expertise to manufacture, market and distribute the aircraft jointly.

Each company incurs its own separate costs, such as labour costs, manufacturing costs, supplies, inventory of unused parts and work in progress. Each company recognises its separately incurred costs in full.

Being a separate entity, separate set of books is maintained for the joint venture and in the individual books of venturers the investment in joint venture is recorded as investment (AS 13). Joint venture can be a foreign company operating in India through an Indian concern say Gremo Insurance of Germany contributes 49% of the assets in joint venture in India with Indo Bank Ltd. of India. They agreed to share the net results in 1:1 ratio. The main objective of the joint venture is to exploit the technical expertise of Gremo Insurance and Goodwill of Indo Bank Ltd. It can also be two or more local concerns opening an organization or firm or company contributing their assets to this new joint venture concern and share the profits of the operation in the agreed ratio.

(Refer Illustration 3)

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3.9 CONSOLIDATED FINANCIAL STATEMENTS OF A VENTURER

Proportionate consolidation is a method of accounting and reporting whereby a venturer's share of each of the assets, liabilities, income and expenses of a jointly controlled entity is reported as separate line items in the venturer's financial statements.

Proportionate consolidation method of accounting is to be followed except in the following cases:

- **a.** Investment is intended to be temporary because the investment is acquired and held exclusively with a view to its subsequent disposal in the near future. And
- **b.** joint venture operates under severe long-term restrictions, which significantly impair its ability to transfer funds to the venturers.

  In both the above cases, investment of venturer in the share of the investee is treated as investment according to AS 13.

A venturer should discontinue the use of the proportionate consolidation method from the date that:

- **a.** It ceases to have joint control in the joint venture but retains, either in whole or in part, its investment.
- **b.** The use of the proportionate consolidation method is no longer appropriate because the joint venture operates under severe long-term restrictions that significantly impair its ability to transfer funds to the venturers.

From the date of discontinuing the use of the proportionate consolidation method,

- **a.** If interest in entity is more than 50%, investments in such joint ventures should be accounted for in accordance with AS 21, Consolidated Financial Statement.
- **b.** If interest is 20% or more but up to 50%, investments are to be accounted for in accordance with AS 23, Accounting for Investment in Associates in Consolidated Financial Statement.
- **c.** For all other cases investment in joint venture is treated as per AS 13, Accounting for Investment.
- **d.** For this purpose, the carrying amount of the investment at the date on which joint venture relationship ceases to exist should be regarded as cost thereafter.

Following are the features of Proportionate Consolidation Method:

- **a.** Stress is given on substance over form i.e., more importance is given to the share of venturers in the profit or loss of the venture from the share of assets and liabilities rather than the nature and form of the joint venture.
- **b.** Venturer’s share of joint assets, liabilities, expenses and income are shown on the separate lines in the consolidated financial statement.

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For example, Mr. A enters into a joint venture with Mr. B and has contributed 33% of the total Property, Plant and Equipment and has share of 40% in current assets and current liabilities. Its share in net result is 50%. Consolidated Balance Sheet will be prepared by Mr. A as follow:

Consolidated Balance Sheet

		Note No.	(Rs.)
I	**Equity and liabilities**		
	1. Shareholders' funds:		
	Share Capital	1	1,00,000
	2. Current Liabilities	2	50,000
			1,50,000

		Note No.	(Rs.)
II	Assets		
	Non-current Assets		
	Property, Plant and Equipment	3	75,000
	Current Assets	4	75,000
			1,50,000

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Notes to Accounts

1.	Share Capital *:		
	A (25,000 + 30,000 - 20,000)	35,000	
	B (50,000 + 45,000 - 30,000)	65,000	1,00,000
2.	Current Liabilities:		
	A	20,000	
	B	30,000	50,000
3.	Property, Plant and Equipment:		
	A	25,000	
	B	50,000	75,000
4.	Current Assets:		
	A	30,000	
	B	45,000	75,000

* Contribution to Share capital taken as a balancing figure in absence of information in this regard in the example

Similar to above all the items of expenses and income will also be classified line by line for each item. The whole basis of this provision is to bring transparency in the books of account. If there is any special clause for sharing of expenses, income or any other item that should be clearly disclosed in the consolidated financial statement.

c. Most of the provisions of Proportionate Consolidation Method are similar to the provisions of AS 21.

d. As far as possible the reporting date of the financial statements of jointly controlled entity and venturers should be same. If practically it is not possible to draw up the financial statements to such date and, accordingly, those financial statements are drawn up to different reporting dates, adjustments should be made in joint venturer's books for the effects of significant transactions or other events that occur between the jointly controlled entity's date and the date of the venturer's financial statements. In any case, the difference between reporting dates should not be more than six months.

e. Accounting policies followed in the preparation of the financial statements of the jointly controlled entity and venturer should be uniform for like transactions and other events in similar circumstances. If accounting policies followed by venturer and jointly controlled entity are not uniform, then adjustments should be made in the items of the venturer to bring it in line with the accounting policy of the joint venture.

f. Any asset or liability should not be adjusted by another liability or asset. Similarly any income or expense cannot be adjusted with another expense or income. Such adjustment can be made only when legally it is allowed to adjust them and such items does lead to settlement of obligation or writing off of assets.

g. On the date when interest in joint entity is acquired, if the interest of venturer in net assets of the entity is less than the cost of investment in joint entity, the difference will be recognized as goodwill in the consolidated financial statement and if net asset is more than cost of investment, then the difference is recognized as capital reserve. In case the carrying amount of investment is different than cost of investment, we take carrying amount for the purpose of the above calculation.

h. An investor who don't have joint control in the entity is like associate as discussed in AS 23, therefore the treatment of losses will be similar to AS 23. If investor's share in loss of the joint entity is in excess of his interest in net asset, this excess loss will be recognized by the venturers. In future when entity starts reporting profits, investor's share of profits will be provided to venturer till total amount is equivalent to absorbed losses.

(Refer Illustration 4)

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3.10 TRANSACTIONS BETWEEN A VENTURER AND JOINT VENTURE

When venturer transfers or sells assets to Joint Venture, the venturer should recognise only that portion of the gain or loss which is attributable to the interests of the other venturers. The venturer should recognise the full amount of any loss only when the contribution or sale provides evidence of a reduction in the net realisable value of current assets or an impairment loss.

When the venturer from the joint venture purchases the assets, venturer will not recognized his share of profits in the joint venture of such transaction unless he disposes off the assets. A venturer should recognise his share of the losses resulting from these transactions in the same way as profits except that losses will be recognised in full immediately only when they represent a reduction in the net realisable value of current assets or an impairment loss.

In case the joint venture is in the form of separate entity (i.e., JCE) then provisions of above the Para will be followed only for consolidated financial statement and not for venturer's own financial statement. In the books of venturer, profit or loss from such transactions are recognised in full.

Example

A and B established a separate vehicle i.e., entity J, wherein each operator has a 50% ownership interest and each takes 50% of the output. On formation of the joint venture, A contributed a property with fair value of Rs. 110 crore and agreed to contribute his experience over the years towards this venture; and B contributed equipment with a fair value of Rs. 120 crore. The carrying values of the contributed assets were Rs. 100 crore and Rs. 80 crore, respectively.

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Answer

A – Gain in consolidated financial statements

A's share in the fair value of assets contributed by entity	
B (50% × 120)	60
A's share in the carrying value of asset contributed by	
A to the joint venture (50% × 100)	(50)
Gain recognised by A	10

3.11 REPORTING INTERESTS IN JOINT VENTURES IN THE FINANCIAL STATEMENTS OF AN INVESTOR

The investors who don't have joint control over the entity recognized his share of net results and his investments in joint venture as per AS 13. In the consolidated financial statement it is recognized as per AS 13, AS 21 or AS 23 as appropriate.

3.12 OPERATORS OF JOINT VENTURES

Payment to operators is recognized as expense in CFS and in the books of the operators as per AS 9, Revenue Recognition. The operator may be any of the venturers, in this case any amount received by him, as management fees for the service will be recognized as stated above in this Para.

3.13 DISCLOSURE

A venturer should disclose the aggregate amount of the following contingent liabilities, unless the probability of loss is remote, separately from the amount of other contingent liabilities:

a. Any contingent liabilities that the venturer has incurred in relation to its interests in joint ventures and its share in each of the contingent liabilities which have been incurred jointly with other venturers;

b. Its share of the contingent liabilities of the joint ventures themselves for which it is contingently liable; and

c. Those contingent liabilities that arise because the venturer is contingently liable for the liabilities of the other venturers of a joint venture.

A venturer should disclose the aggregate amount of the following commitments in respect of its interests in joint ventures separately from other commitments:

a. Any capital commitments of the venturer in relation to its interests in joint ventures and its share in the capital commitments that have been incurred jointly with other venturers; and

b. Its share of the capital commitments of the joint ventures themselves.

A venturer should disclose a list of all joint ventures and description of interests in significant joint ventures. In respect of jointly controlled entities, the venturer should also disclose the proportion of ownership interest, name and country of incorporation or residence. A venturer should disclose, in its separate financial statements, the aggregate amounts of each of the assets, liabilities, income and expenses related to its interests in the jointly controlled entities.

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Reference: The students are advised to refer the full text of AS 27 “Financial Reporting of Interests in Joint Ventures”

ILLUSTRATIONS

Illustration 1

Mr. A, Mr. B and Mr. C entered into a joint venture to purchase a land, construct and sell flats. Mr. A purchased a land for Rs. 60,00,000 on 01.01.20X1 and for the purpose he took loan from a bank for Rs. 50,00,000 @ 8% interest p.a. He also paid registering fees Rs. 60,000 on the same day. Mr. B supplied the materials for Rs. 4,50,000 from his godown and further he purchased the materials for Rs. 5,00,000 for the joint venture. Mr. C met all other expenses of advertising, labour and other incidental expenses which turnout to be Rs. 9,00,000. On 30.06.20X1 each of the venturer agreed to take away one flat each to be valued at Rs. 10,00,000 each flat and rest were sold by them as follow: Mr. A for Rs. 40,00,000; Mr. B for Rs. 20,00,000 and Mr. C for Rs. 10,00,000. Loan was repaid on the same day by Mr. A along with the interest and net proceeds were shared by the partners equally. You are required to prepare the draft Consolidated Profit & Loss Account and Joint Venture Account in the books of each venturer.

SOLUTION

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Draft Consolidated Profit & Loss Account

Particulars	Rs.	Rs.	Particulars	Rs.	Rs.
To Purchase of Land:			By Sale of Flats:		
Mr. A		60,00,000	Mr. A	40,00,000	
To Registration Fees:			Mr. B	20,00,000	
Mr. A		60,000	Mr. C	10,00,000	70,00,000
To Materials:			By Flats taken by Venturers:		
Mr. B		9,50,000	Mr. A	10,00,000	
To Other Expenses:			Mr. B	10,00,000	
Mr. C		9,00,000	Mr. C	10,00,000	30,00,000
To Bank Interest:					
Mr. A		2,00,000			
To Profits:					
Mr. A	6,30,000				
Mr. B	6,30,000				
Mr. C	6,30,000	18,90,000			
		1,00,00,000			1,00,00,000

In the Books of Mr. A

Joint Venture Account

Particulars	Rs.	Particulars	Rs.
To Bank Loan (Purchase of Land)	50,00,000	By Bank (Sale of Flats)	40,00,000
		By Land & Building	10,00,000
To Bank:(Purchase of Land)	10,00,000		
		By Bank (Received from Mr. B)	14,20,000
To Bank (Registration Fees)	60,000		
To Bank (Bank Interest)	2,00,000	By Bank (Received from Mr. C)	4,70,000
To Profit on JV	6,30,000		
	68,90,000		68,90,000

In the Books of Mr. B

Joint Venture Account

Particulars	Rs.	Particulars	Rs.
To Purchases (Material Supplied)	4,50,000	By Bank (Sale of Flats)	20,00,000
To Bank (Materials)	5,00,000	By Land & Building	10,00,000
To Profit on JV	6,30,000		
To Bank (Paid to Mr. A)	14,20,000		
	30,00,000		30,00,000

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In the Books of Mr. C

Joint Venture Account

Particulars	Rs.	Particulars	Rs.
To Bank (Misc. Expenses)	9,00,000	By Bank (Sale of Flats)	10,00,000
To Profit on JV	6,30,000	By Land & Building	10,00,000
To Bank (Paid to Mr. A)	4,70,000		
	20,00,000		20,00,000

Illustration 2

A Ltd., B Ltd. and C Ltd. decided to jointly construct a pipeline to transport the gas from one place to another that was manufactured by them. For the purpose following expenditure was incurred by them: Buildings Rs. 12,00,000 to be depreciated @ 5% p.a., Pipeline for Rs. 60,00,000 to be depreciated @ 15% p.a., computers and other electronics for Rs. 3,00,000 to be depreciated @ 40% p.a. and various vehicles of Rs. 9,00,000 to be depreciated @ 20% p.a.

They also decided to equally bear the total expenditure incurred on the maintenance of the pipeline that comes to Rs. 6,00,000 each year.

You are required to show the consolidated balance sheet and the extract of Statement of Profit & Loss and Balance Sheet for each venturer.

Solution

Consolidated Balance Sheet

		Note	**(Rs.)**
I	**Equity and liabilities**		
	Shareholders' funds:		
	Share Capital	1	71,40,000
			71,40,000
II	**Assets**		
	Non-current Assets		
	Property, Plant and Equipment:	2	71,40,000
			71,40,000

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Notes to Accounts

			(Rs.)
1.	Share capital		
	A Ltd.	23,80,000	
	B Ltd.	23,80,000	
	C Ltd.	23,80,000	71,40,000
2.	Property, Plant and Equipment		
	Land & Building:		
	A Ltd.	3,80,000	
	B Ltd.	3,80,000	
	C Ltd.	3,80,000	11,40,000
	Plant & Machinery:		

	A Ltd.	17,00,000	
	B Ltd.	17,00,000	
	C Ltd.	17,00,000	51,00,000
	Computers:		
	A Ltd.	60,000	
	B Ltd.	60,000	
	C Ltd.	60,000	1,80,000
	Vehicles:		
	A Ltd.	2,40,000	
	B Ltd.	2,40,000	
	C Ltd.	2,40,000	7,20,000

In the Books of A Ltd. Extract of statement of Profit & Loss

Particulars	Note No.	Rs.
Depreciation and amortisation expense	1	4,20,000
Other operating Expenses (Pipeline Expenses)		200,000

Extract of Balance Sheet

	Note No.	Rs.
Assets		
Non-current assets		
Property, Plant and Equipment	2	23,80,000

Notes to Accounts

		Rs.	Rs.
1.	Depreciation and amortisation expense		
	Land & Building	20,000	
	Plant & Machinery	3,00,000	
	Computers	40,000	
	Vehicles	60,000	4,20,000
2.	Land & Building	4,00,000	
	Less: Depreciation	(20,000)	3,80,000
	Plant & Machinery	20,00,000	
	Less: Depreciation	(3,00,000)	17,00,000
	Computers	1,00,000	
	Less: Depreciation	(40,000)	60,000

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	Vehicles	3,00,000	
	Less: Depreciation	(60,000)	2,40,000
			23,80,000

In the Books of B Ltd. Extract of draft Profit & Loss Account

Particulars	**Note No.**	**Rs.**
Depreciation and amortisation expense	1	4,20,000
Other operating Expenses (Pipeline Expenses)		200,000

Extract of Balance Sheet

	Note No.	**Rs.**
Assets		
Non-current assets		
Property, Plant and Equipment	2	23,80,000

Notes to Accounts

		Rs.	**Rs.**
1.	Depreciation and amortisation expense		
	Land & Building	20,000	
	Plant & Machinery	3,00,000	
	Computers	40,000	
	Vehicles	60,000	4,20,000
2.	Land & Building	4,00,000	
	Less: Depreciation	(20,000)	3,80,000
	Plant & Machinery	20,00,000	
	Less: Depreciation	(3,00,000)	17,00,000
	Computers	1,00,000	
	Less: Depreciation	(40,000)	60,000
	Vehicles	3,00,000	
	Less: Depreciation	(60,000)	2,40,000
			23,80,000

In the Books of C Ltd.

Extract of Draft Profit & Loss Account	**Note No.**	**Rs.**
Depreciation and amortisation expense	1	4,20,000
Other operating Expenses (Pipeline Expenses)		200,000

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Extract of Balance Sheet

	Note No.	Rs.
Assets		
Non-current assets		
Property, Plant and Equipment	2	23,80,000

Notes to Accounts

		Rs.	Rs.
1.	Depreciation and amortisation expense		
	Land & Building	20,000	
	Plant & Machinery	3,00,000	
	Computers	40,000	
	Vehicles	60,000	4,20,000
2.	Land & Building	4,00,000	
	Less: Depreciation	(20,000)	3,80,000
	Plant & Machinery	20,00,000	
	Less: Depreciation	(3,00,000)	17,00,000
	Computers	1,00,000	
	Less: Depreciation	(40,000)	60,000
	Vehicles	3,00,000	
	Less: Depreciation	(60,000)	2,40,000
			23,80,000

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Illustration 3

A Ltd. a UK based company entered into a joint venture with B Ltd. in India, wherein B Ltd. will import the goods manufactured by A Ltd. on account of joint venture and sell them in India. A Ltd. and B Ltd. agreed to share the expenses & revenues in the ratio of 5:4 respectively whereas profits are distributed equally. A Ltd. invested 49% of total capital but has equal share in all the assets and is equally liable for all the liabilities of the joint venture. Following is the trial balance of the joint venture at the end of the first year:

Particulars	Dr. (Rs.)	Cr. (Rs.)
Purchases	**9,00,000**	
Other Expenses	**3,06,000**	
Sales		**13,05,000**
Property, Plant and Equipment	**6,00,000**	

Current Assets	**2,00,000**	
Unsecured Loans		**2,00,000**
Current Liabilities		**1,00,000**
Capital		**4,01,000**

Closing inventory was valued at Rs. 1,00,000.

You are required to prepare the Consolidated Financial Statement.

Solution

Consolidated Profit & Loss Account

	Note No.	Rs.
Revenue from operations	1	13,05,000
Total Revenue (A)		13,05,000
Less: Expenses	2	9,00,000
Purchases Other expenses	3	3,06,000
Changes in inventories of finished goods	4	(1,00,000)
Total Expenses (B)		11,06,000
Profit Before Tax (A-B)		1,99,000

Consolidated Balance Sheet

		Note No.	Rs.
I	**Equity and liabilities**		
	1. Shareholders' funds:		
	Share Capital	5	4,01,000
	Reserves and Surplus	6	1,99,000
	2. Non-current liabilities		
	Long term borrowings	7	2,00,000
	3. Current Liabilities	8	1,00,000
			9,00,000
II	**Assets**		
	Non-current Assets		
	Property, Plant and Equipment	9	6,00,000
	Current Assets		
	Inventories	10	1,00,000
	Other current assets	11	2,00,000
			9,00,000

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Notes to Accounts

			(Rs.)
1.	**Revenue from operations**		
	Sales:		
	A Ltd.	7,25,000	
	B Ltd.	5,80,000	13,05,000
2.	**Purchases**		
	A Ltd.	5,00,000	
	B Ltd.	4,00,000	9,00,000
3.	**Other expenses**		
	A Ltd.	1,70,000	
	B Ltd.	1,36,000	3,06,000
4.	**Closing Inventory**		
	A Ltd.	50,000	
	B Ltd.	50,000	1,00,000
5.	**Share Capital**		
	A Ltd.	1,96,490	
	B Ltd.	2,04,510	4,01,000
6.	**Reserves and Surplus**		
	Profit & Loss Account:		
	A Ltd.	99,500	
	B Ltd.	99,500	1,99,000
7.	**Long Term Borrowings**		
	Unsecured Loans:		
	A Ltd.	1,00,000	
	B Ltd.	1,00,000	2,00,000
8.	**Current Liabilities**		
	A Ltd.	50,000	
	B Ltd.	50,000	1,00,000
9.	**Property, Plant and Equipment**		
	A Ltd.	3,00,000	
	B Ltd.	3,00,000	6,00,000

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10.	Inventories		
	A Ltd.	50,000	
	B Ltd.	50,000	1,00,000
11.	**Other Current Assets**		
	A Ltd.	1,00,000	
	B Ltd.	1,00,000	2,00,000

Illustration 4

A Ltd. entered into a joint venture with B Ltd. on 1:1 basis and a new company C Ltd. was formed for the same purpose and following is the balance sheet of all the three companies:

Particulars	A Ltd.	B Ltd.	C Ltd.
Share Capital	10,00,000	7,50,000	5,00,000
Reserve & Surplus	18,00,000	16,00,000	12,00,000
Loans	3,00,000	4,00,000	2,00,000
Current Liabilities	4,00,000	2,50,000	1,00,000
Property, Plant and Equipment	30,50,000	26,25,000	19,50,000
Investment in JV	2,50,000	2,50,000	-
Current Assets	2,00,000	1,25,000	50,000

Prepare the balance sheet of A Ltd. and B Ltd. under proportionate consolidation method.

Solution

Balance Sheet of A Ltd.

		Note No.	(Rs.)
I	**Equity and liabilities**		
	1. Shareholders' funds:		
	Share Capital		1,00,000
	Reserves and Surplus	1	24,00,000
	2. Non-current liabilities	2	4,00,000
	3. Current Liabilities	3	4,50,000
	TOTAL		42,50,000
		Note No.	**(Rs.)**
II	**Assets**		
	Non-current Assets		
	Property, Plant and Equipment:	4	40,25,000

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	Current Assets	5	2,25,000
			42,50,000

Notes to Accounts

		(Rs.)	(Rs.)
1.	Reserves and Surplus		
	A Ltd.	18,00,000	
	C Ltd.	6,00,000	24,00,000
2.	Long Term Borrowings Loans:		
	A Ltd.	3,00,000	
	C Ltd.	1,00,000	4,00,000
3.	Current Liabilities:		
	A Ltd.	4,00,000	
	C Ltd.	50,000	4,50,000
4.	Property, Plant and Equipment:		
	A Ltd.	30,50,000	
	C Ltd.	9,75,000	40,25,000
5.	Current Assets:		
	A Ltd.	2,00,000	
	C Ltd.	25,000	2,25,000

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Balance Sheet of B Ltd.

		Note No.	(Rs.)
I	**Equity and liabilities**		
	1. Shareholders' funds:		
	Share Capital		7,50,000
	Reserves and Surplus	1	22,00,000
	2. Non-current liabilities	2	5,00,000
	3. Current Liabilities	3	3,00,000
			37,50,000
II	**Assets**		
	1. Non-current Assets		
	Property, Plant and Equipment:	4	36,00,000
	2. Current Assets	5	1,50,000
			37,50,000

Notes to Accounts

		Rs.	(Rs.)
1.	Reserves and Surplus		
	A Ltd.	16,00,000	
	C Ltd.	6,00,000	22,00,000
2.	Long Term Borrowings Loans:		
	A Ltd.	4,00,000	
	C Ltd.	1,00,000	5,00,000
3.	Current Liabilities:		
	A Ltd.	2,50,000	
	C Ltd.	50,000	3,00,000
4.	Property, Plant and Equipment:		
	A Ltd.	26,25,000	
	C Ltd.	9,75,000	36,00,000
5.	Current Assets:		
	A Ltd.	1,25,000	
	C Ltd.	25,000	1,50,000

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TEST YOUR KNOWLEDGE

MCQs

1. **State which of the following statements are incorrect.**
   i. **The requirements relating to accounting for joint ventures in consolidated financial statements according to proportionate consolidation method, as contained in AS 27, applies only when consolidated financial statements are prepared by venturer.**
   ii. **The requirements relating to accounting for joint ventures in consolidated financial statements according to proportionate consolidation method, as contained in AS 27, applies irrespective whether consolidated financial statements are prepared by venturer or not.**
   iii. **An investor in joint venture, which does not have joint control, should report its interest in a joint venture in its consolidated financial statements in accordance with AS 13, AS 21 and AS 23as the case may be.**
   a. **Point i. is incorrect.**
   b. **Point ii. is incorrect.**
   c. **Point iii. is incorrect.**
   d. **None of the above**

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2. **Identify which of the following is not a feature of a Jointly controlled operations (JCO):**
   a. **Each venturer has his own separate business.**
   b. **There is a separate entity for joint venture business.**
   c. **Each venturer record only his own transactions without any separately set of books maintained for the joint venture business.**
   d. **There is a common agreement between all of them.**

3. **Identify which of the following is/are not a feature of a Jointly controlled assets (JCA):**
   i. **There is a separate legal identity.**
   ii. **There is a common control over the joint assets.**
   iii. **Expenses on jointly held assets are shared by the venturers as per the contract.**
   iv. **In their financial statement, venturer shows only their share of the asset and total income earned by them along with total expenses incurred by them.**
   a. **Point no. i. only.**
   b. **Point no. i. and iii.**
   c. **Point no. iii. and iv.**
   d. **Point i. and ii.**

4. **Identify which is/ are features of a Jointly controlled entity (JCE):**
    i. **Venturer creates a new entity for their joint venture business.**
    ii. **All the venturers pool their resources under new banner and this entity purchases its own assets, create its own liabilities, expenses are incurred by the entity itself and sales are also made by this entity.**
    iii. **The revenues and expenses of the entity is shared by the venturers in the ratio agreed upon in the contractual agreement.**
    a. **Point no. i. only.**
    b. **Point no. i. and ii.**
    c. **Point no. iii.**
    d. **Point no. iii.**

5. **Identify the correct statements. From the date of discontinuing the use of the proportionate consolidation method:**
    i. **If interest in entity is more than 50%, investments in such joint ventures should be accounted for in accordance with AS 21, Consolidated Financial Statements.**
    ii. **If interest is 20% or more but up to 50%, investments are to be accounted for in accordance with AS 23, Accounting for Investment in Associates in Consolidated Financial Statements.**
    iii. **For all other cases investment in joint venture is treated as per AS 13, Accounting for Investments.**
    iv. **For this purpose, the fair value of the investment at the date on which joint venture relationship ceases to exist should be regarded as cost thereafter.**
    a. **Point no. i. and ii.**
    b. **Point no. i., ii. and iii.**
    c. **Point no. i., ii., iii. and iv.**
    d. **None of the above.**

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ANSWERS/SOLUTION

MCQs

1.	**b.**	Point ii. is incorrect.
2.	**b.**	There is a separate entity for joint venture business.
3.	**a.**	Point no. i. only.
4.	**c.**	Point no. iii.
5.	**b.**	Point no. 1, 2 and 3.

THEORY QUESTIONS

Q.NO.1. Describe the cases when AS 27 does not allow the use of Proportionate consolidation method of accounting?

ANSWER

Proportionate consolidation method of accounting is to be followed except in the following cases:

a. Investment is intended to be temporary because the investment is acquired and held exclusively with a view to its subsequent disposal in the near future.

The term 'Near Future' is explained with AS 21.

Or

b. Joint venture operates under severe long-term restrictions, which significantly impair its ability to transfer funds to the venturers.

In both the above cases, investment of venturer in the share of the investee is treated as investment according to AS 13.

Q.NO.2. When is a venturer required to discontinue the use of the proportionate consolidation method?

ANSWER

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A venturer should discontinue the use of the proportionate consolidation method from the date that:

a. It ceases to have joint control in the joint venture but retains, either in whole or in part, its investment.

b. The use of the proportionate consolidation method is no longer appropriate because the joint venture operates under severe long term restrictions that significantly impair its ability to transfer funds to the venturers.

From the date of discontinuing the use of the proportionate consolidation method,

a. If interest in entity is more than 50%, investments in such joint ventures should be accounted for in accordance with AS 21, Consolidated Financial Statement.

b. If interest is 20% or more but up to 50%, investments are to be accounted for in accordance with AS 23, Accounting for Investment in Associates in Consolidated Financial Statement.

c. For all other cases investment in joint venture is treated as per AS 13, Accounting for Investment.

d. For this purpose, the carrying amount of the investment at the date on which joint venture relationship ceases to exist should be regarded as cost thereafter.

PRACTICAL QUESTIONS

Q.NO.1. JVR Limited has made investments of Rs. 97.84 crores in equity shares of QSR Limited in pursuance of Joint Venture agreement till 20X1-X2 (i.e., more than 12 months). The investment has been made at par. QSR Limited has been in continuous losses for the last 2 years. JVR Limited is willing to reassess the carrying amount of its investment in QSR Limited and wish to provide for diminution in value of investments. However, QSR Limited has a futuristic and profitable business plans and projection for the coming years. Discuss whether the contention of JVR Limited to bring down the carrying amount of investment in QSR Limited is in accordance with the Accounting Standard.

SOLUTION

As per para 26 of AS 27 "Financial Reporting of Interests in Joint Ventures", in a venturer's separate financial statements, interest in a jointly controlled entity should be accounted for as an investment in accordance with AS 13 'Accounting for Investments'.

As per para 17 of AS 13 "Accounting for Investments", long-term investments are usually carried at cost. However, when there is a decline, other than temporary, in the value of a long-term investment, the carrying amount is reduced to recognize the decline. Indicators of the value of an investment are obtained by reference to its market value, the investee's assets and results and the expected cash flows from the investment. The type and extent of the investor's stake in the investee are also taken into account. However, where there is a decline, other than temporary, in the carrying amounts of long-term investments, the resultant reduction in the carrying amount is charged to the profit and loss statement.

Since the investment was made in the year 20X1-20X2 i.e., more than a year, it is a long-term investment. In the given case, though the QSR Ltd. is in continuous losses for past 2 years, yet it has a futuristic and profitable business plans and projections for the coming years. Here, one of the indicators i.e. 'losses incurred to the company' may lead to diminution in the value of the shares while the other indicator that 'the company has positive expected cash flows from its business plans' does not lead to decline in the value of shares.

Considering both the facts, in case the expectation of profitable business plans and positive cash flows is based reliable presumptions (such as tender in favour of QSR Ltd., strong order book etc.), the decline will be regarded as temporary in nature and the investment in equity shares will continue to be carried at cost only.

However, should the aforesaid presumptions be based on projections without reasonable evidence backing the claims, the decline could be regarded as non-temporary in nature in which case the write down of the carrying amount become necessary in line with AS 13, thereby implying the contention of QSR Ltd. to be correct.

THE END

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