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P1: ADVANCED ACCOUNTING (MODULE – 1)

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1. INTRODUCTION TO ACCOUNTING STANDARDS

LEARNING OUTCOMES

After studying this chapter, you will be able to:

- Understand the concept of Accounting Standards;
- Grasp the objectives and benefits of Accounting Standards;
- Learn the standards setting process;
- Familiarize with the status of Accounting Standards in India;
- Recognize the International Accounting Standard Authorities;
- Appreciate the emergence of International Financial Reporting Standards as global standards;
- Differentiate between convergence vs. adoption;
- Know the process of convergence of IFRS in India;
- Understand the concept of Ind AS;
- Understand the objectives and concepts of carve outs/ins.

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1. INTRODUCTION

Generally Accepted Accounting Principles

Generally accepted accounting principles (GAAP) refer to a common set of accepted accounting principles, standards, and procedures that business reporting entity must follow when it prepares and presents its financial statements.

GAAP is a combination of authoritative standards (set by policy boards) and the commonly accepted ways of recording and reporting accounting information. At international level, such authoritative standards are known as International Financial Reporting Standards (IFRS) at many places and in India we have authoritative standards named as Accounting Standards (ASs) and Indian Accounting Standard (Ind AS).

Accounting Standards (ASs) are written policy documents issued by the Government with the support of other regulatory bodies e.g., Ministry of Corporate Affairs (MCA) issuing Accounting Standards for corporates in consultation with National Financial Reporting Authority (NFRA) covering the following aspects of accounting transaction or events in the financial statements:

- Recognition;
- Measurement;
- Presentation; and
- Disclosure.

The ostensible purpose of the standard setting bodies is to promote the dissemination of timely and useful financial information to investors and certain other stakeholders, having an interest in the company's economic performance.

Accounting Standards reduce the accounting alternatives in the preparation of financial statements within the bounds of rationality, thereby, ensuring comparability of financial statements of different enterprises.

Accounting Standards deal with the following aspects:

i. recognition of events and transactions in the financial statements;

ii. measurement of these transactions and events;

iii. presentation of these transactions and events in the financial statements in a manner that is meaningful and understandable to the reader; and

iv. the disclosures relating to these transactions and events to enable the public at large and the stakeholders and the potential investors in particular, to get an insight into what these financial statements are trying to reflect and thereby facilitating them to take prudent and informed business decisions.

Accounting Standards deal with aspects of accounting events			
Recognition of events and transactions	Measurement of transactions and events	Presentation of transactions and events	Disclosure requirements

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The following are the benefits of Accounting Standards:

i. **Standardisation of alternative accounting treatments:** Accounting Standards reduce or eliminate, to a reasonable extent, any confusing variations in the accounting treatment and presentation of economic events while preparing financial statements.

The standard policies are intended to reflect a consensus on accounting policies to be used in different identified areas, e.g. inventory valuation, capitalisation of costs, depreciation and amortisation, etc.

Since it is not possible to prescribe a single set of policies for any specific accounting area that would be appropriate for all enterprises, it is not enough to comply with the standards and state that they have been followed.

In other words, one must also disclose the accounting policies used in preparation of financial statements. (Refer AS 1, Disclosure of Accounting Policies given in Accounting Pronouncements).

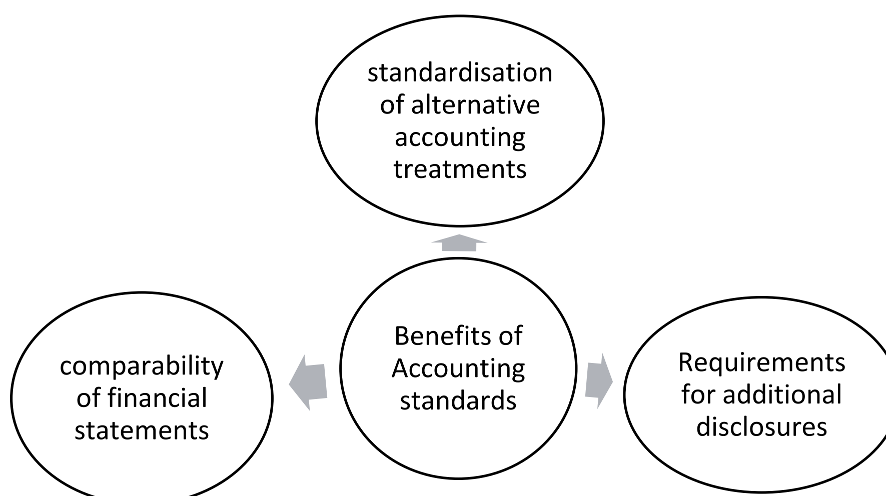
For example, an enterprise should disclose which of the permitted cost formula (FIFO, Weighted Average, etc.) has actually been used for ascertaining inventory costs.

ii. **Requirements for additional disclosures:** There are certain areas where information is not statutorily required to be disclosed. However, accounting standards may call for appropriate disclosures of accounting policies followed and other required information in the financial statements which would be helpful for readers to understand the accounting treatment done for various items in those financial statements.

iii. **Comparability of financial statements:** In addition to improving credibility of accounting data, standardisation of accounting procedures improves comparability of financial statements, both intra-enterprise and inter-enterprise. Such comparisons are very effective and most widely used tools for assessment of enterprise's financial health and performance by users of financial statements for taking economic decisions, e.g., whether or not to invest, whether or not to lend and so on.

The intra-enterprise comparison involves comparison of financial statements of same enterprise over a number of years. The intra-enterprise comparison is possible if the enterprise uses same accounting policies every year in drawing up its financial statements.

The inter-enterprise comparison involves comparison of financial statements of different enterprises for same accounting period. This is possible only when comparable enterprises use similar accounting policies in preparation of respective financial statements (or in case the policies are slightly different, the same are disclosed in the financial statements). The disclosure of accounting policies allows a user to make appropriate adjustments while comparing the financial statements of comparable enterprises.



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Since Accounting Standards are principle based, application of Accounting Standards becomes judgemental in case of complex business transactions. Accounting Standards have to be read in line with the legal requirements, i.e., in case of any conflict, Statute would prevail over Accounting Standards.

Another advantage of standardisation is reduction of scope for creative accounting. The creative accounting refers to twisting of accounting policies to produce financial statements favourable to a particular interest group. For example, it is possible to overstate profits and assets by capitalising revenue expenditure or to understate them by writing off a capital expenditure against revenue of current accounting period. Such practices can be curbed only by framing policies for capitalisation, particularly for the borderline cases where it is possible to have divergent views. The accounting standards provide adequate guidance in this regard.

2. STANDARDS SETTING PROCESS

The Institute of Chartered Accountants of India (ICAI), being a premier accounting body in the country, took upon itself the leadership role by constituting the Accounting Standards Board (ASB) in 1977. The ICAI has taken significant initiatives for the issuance of Accounting Standards to ensure that the standard setting process is fully consultative and transparent. The ASB considered the International Accounting Standards (IASs)/International Financial Reporting Standards (IFRSs) while framing Accounting Standards (ASs) in India and tried to integrate them, in the light of the applicable laws, customs, usages and business environment in the country. The composition of ASB includes representatives of industries, associations of industries (namely, ASSOCHAM, CII, FICCI), regulators, academicians, government departments, etc. Although ASB is a body constituted by the Council of the ICAI, it (ASB) is independent in the formulation of accounting standards. NFRA recommend these standards to the MCA. MCA has to spell out the accounting standards applicable for companies in India.

The standard-setting procedure of ASB can be briefly outlined as follows:

- **Step I – Identification of area:**

  Identification of broad areas by ASB for formulation of AS.

- **Step II – Constitution of study groups:**

  Constitution of study groups by ASB to consider specific projects and to prepare preliminary drafts of the proposed accounting standards. The draft normally includes objective and scope of the standard, definitions of the terms used in the standard, recognition and measurement principles wherever applicable and presentation and disclosure requirements.

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Consideration of the preliminary draft prepared by the study group of ASB and revision, if any, of the draft on the basis of deliberations.

- **Step III - Preparation of draft and its circulation:**
  Circulation of draft of accounting standard (after revision by ASB) to the Council members of the ICAI and specified outside bodies such as MCA, Securities and Exchange Board of India (SEBI), Comptroller and Auditor General of India (C&AG), Central Board of Direct Taxes (CBDT), Standing Conference of Public Enterprises (SCOPE), etc. for comments.

- **Step IV - Ascertainment of views of different bodies on draft:**
  Meeting with the representatives of the specified outside bodies to ascertain their views on the draft of the proposed accounting standard.

- **Step V - Finalisation of exposure draft (E.D.):**
  Finalisation of the exposure draft of the proposed accounting standard and its issuance inviting public comments.

- **Step VI – Comments received on exposure draft (E.D.):**
  Consideration of comments received on the exposure draft and finalisation of the draft accounting standard by the ASB for submission to the Council of the ICAI for its consideration and approval for issuance.
- **Step VII – Modification of the draft:**
  Consideration of the final draft of the proposed standard by the Council of the ICAI and if found necessary, modification of the draft in consultation with the ASB is done.

- **Step VIII – Issue of AS:**
  The accounting standard on the relevant subject (for non-corporate entities) is then issued by the ICAI. For corporate entities the accounting standards are issued by the Ministry of Corporate Affairs in consultation with the NFRA.

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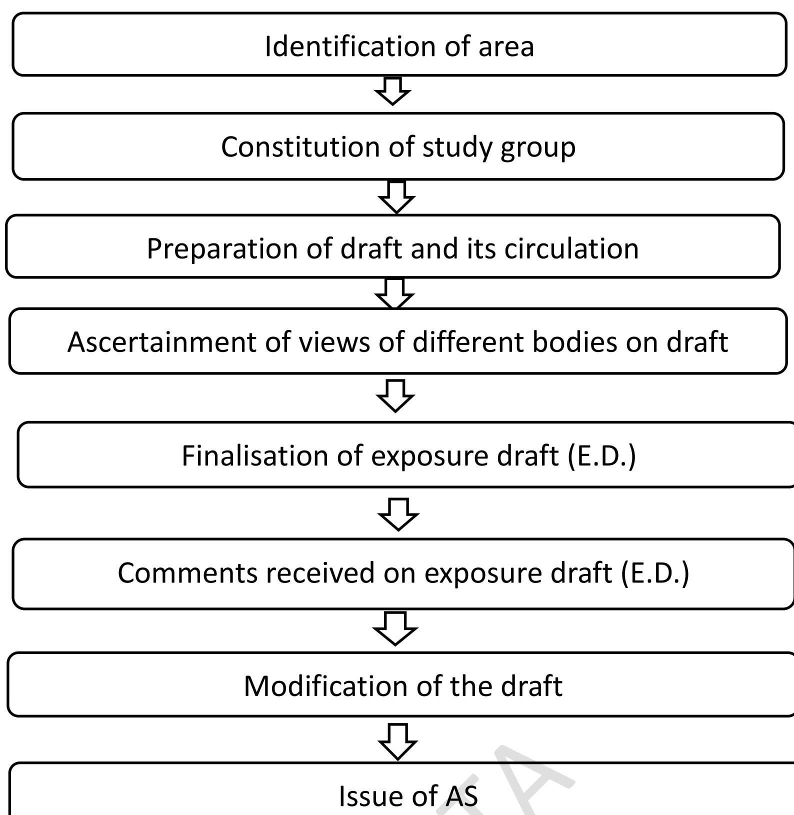
Standard – Setting Process



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Earlier, ASB used to issue Accounting Standard Interpretations (ASIs) which address questions that arise in course of application of standard. These were, therefore, issued after issuance of the relevant standard. Authority of the ASIs was same as that of the AS to which it relates.

However, after notification of Accounting Standards by the Central Government for the companies, where the consensus portion of ASI was merged as 'Explanation' to the relevant paragraph of the Accounting Standard, the Council of ICAI also decided to merge the consensus portion of ASI as 'Explanation' to the relevant paragraph of the AS issued by them. This initiative was taken by the Council of the ICAI to harmonise both the set of standards, i.e., ASs issued by the ICAI for non-corporates and ASs notified by the MCA for corporates.

It may be noted that as per Section 133 of the Companies Act, 2013, the Central Government may prescribe the standards of accounting or any addendum thereto, as recommended by the ICAI, constituted under section 3 of the Chartered Accountants Act, 1949, in consultation with and after examination of the recommendations made by NFRA.

3. HOW MANY ACCOUNTING STANDARDS?

The Institute of Chartered Accountants of India has, so far, issued 29 Accounting Standards. However, AS 6 on 'Depreciation Accounting' has been withdrawn on revision of AS 10 'Property, Plant and Equipment∗ ' and AS 8 on 'Accounting for Research and Development' has been withdrawn consequent to the issuance of AS 26 on 'Intangible Assets'.

Thus effectively, there are 27 Accounting Standards at present. The 'Accounting Standards' issued by the Accounting Standards Board establish standards which have to be complied by the business entities so that the financial statements are prepared in accordance with GAAP.

In recent times there are various improvements/developments in the global accounting standards which have taken place. In India, Ind AS have become mandatory for certain class of companies as per the MCA roadmap. AS being the guidelines to prepare financial statements, have to keep pace with these changes in global accounting scenarios. Number of fundamental changes have been made in these AS so as to be globally aligned as far as possible.

MCA vide notification date 30th March 2016 announced Companies (Accounting Standards) Amendment Rules, 2016. These rules were superseded by the Companies (Accounting Standards) Rules, 2021 which were notified by the MCA on 23rd June, 2021. Various ASs i.e. AS 2, AS 4, AS 10, AS 13, AS 14, AS 21, AS 29 have been revised to make them in line with corresponding Ind AS to the extent possible.

The following is the list of Accounting Standards with their respective date of applicability:

AS No.	AS Title	Date of applicability
1	Disclosure of Accounting Policies	01/04/1993
2	Valuation of Inventories (Revised)	01/04/1999
3	Cash Flow Statement	01/04/2001
4	Contingencies and Events Occurring after the Balance Sheet Date (Revised)	01/04/1998
5	Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies	01/04/1996
7	Construction Contracts	01/04/2002
9	Revenue Recognition	01/04/1993
10	Property, Plant and Equipment (Revised)	01/04/2016
11	The Effects of Changes in Foreign Exchange Rates (Revised)	01/04/2004
12	Accounting for Government Grants	01/04/1994
13	Accounting for Investments (Revised)	01/04/1995
14	Accounting for Amalgamations (Revised)	01/04/1995
15	Employee Benefits	01/04/2006
16	Borrowing Costs	01/04/2000
17	Segment Reporting	01/04/2001
18	Related Party Disclosures	01/04/2001

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19	Leases	01/04/2001
20	Earnings Per Share	01/04/2001
21	Consolidated Financial Statements (Revised)	01/04/2001
22	Accounting for Taxes on Income	01/04/2006
23	Accounting for Investments in Associates in Consolidated Financial Statements	01/04/2002
24	Discontinuing Operations	01/04/2004
25	Interim Financial Reporting	01/04/2002
26	Intangible Assets	01/04/2003
27	Financial Reporting of Interests in Joint Ventures	01/04/2002
28	Impairment of Assets	01/04/2008
29	Provisions, Contingent Liabilities and Contingent Assets (Revised)	01/04/2004

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NOTE:

In the study material, Accounting Standards have not been discussed sequentially; instead the related Accounting Standards have been grouped and discussed in the ensuing chapters for ease of understanding. For example, the 'Presentation and Disclosure based Accounting Standards like AS 1, AS 3, AS 17, AS 18, AS 20, AS 24 and AS 25 have been grouped in one chapter. The chapter-wise grouping of Accounting Standards, has been discussed in the Study Material, as follows:

Chapter 4 Presentation & Disclosures based Accounting Standards		
AS 1	:	Disclosure of Accounting Policies
AS 3	:	Cash Flow Statements
AS 17	:	Segment Reporting
AS 18	:	Related Party Disclosures
AS 20	:	Earnings Per Share
AS 24	:	Discontinuing Operations
AS 25	:	Interim Financial Reporting
Chapter 5 Assets based Accounting Standards		
AS 2	:	Valuation of Inventories
AS 10	:	Property, Plant and Equipment
AS 13	:	Accounting for Investments
AS 16	:	Borrowing Costs

AS 19	:	Leases
AS 26	:	Intangible Assets
AS 28	:	Impairment of Assets
Chapter 6 Liabilities based Accounting Standards		
AS 15	:	Employee Benefits
AS 29	:	Provisions, Contingent Liabilities and Contingent Assets
Chapter 7 Accounting Standards based on items impacting Financial Statements		
AS 4	:	Contingencies and Events Occurring After the Balance Sheet Date
AS 5	:	Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies
AS 11	:	The Effects of Changes in Foreign Exchange Rates
AS 22	:	Accounting for Taxes on Income
Chapter 8 Revenue based Accounting Standards		
AS 7	:	Construction Contracts
AS 9	:	Revenue Recognition
Chapter 9 Other Accounting Standards		
AS 12	:	Accounting for Government Grants
AS 14	:	Accounting for Amalgamations (excluding inter- company holdings)
Chapter 10 Accounting Standards for Consolidated Financial Statements		
AS 21	:	Consolidated Financial Statements of single subsidiaries (excluding problems involving acquisition of Interest in Subsidiary at Different Dates, Cross holding, Disposal of a Subsidiary and Foreign Subsidiaries).
AS 23	:	Accounting for Investment in Associates in Consolidated Financial Statements
AS 27	:	Financial Reporting of Interests in Joint Ventures

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4. STATUS OF ACCOUNTING STANDARDS

It has already been mentioned that the ASs are developed by the ASB of the ICAI. The Institute not being a legislative body can enforce compliance with its standards only by its members. Also, the standards cannot override laws and local regulations. The ASs are nevertheless made mandatory from the dates specified in respective standards and are generally applicable to all enterprises, subject to certain exceptions. The implication of mandatory status of an AS depends on whether the statute governing the enterprise concerned requires compliance with the ASs. The Companies Act had earlier notified 28 ASs and mandated the corporate entities to comply with the provisions stated therein. However, in 2016 the MCA withdrew AS 6. Hence there are now only 27 notified ASs as per the Companies (Accounting Standards) Rules, 2021.

5. NEED FOR CONVERGENCE TOWARDS GLOBAL STANDARDS

The last decade has witnessed a sea change in the global economic scenario. The emergence of trans-national corporations in search of money, not only for fuelling growth, but to sustain on-going activities has necessitated raising of capital from all parts of the world, cutting across frontiers.

Few key aspects which required the need for convergence are as under:

1. **Raising funds from international markets:**

   Each country has its own set of rules and regulations for accounting and financial reporting. Therefore, when an enterprise decides to raise capital from the markets other than the country in which it is located, the rules and regulations of that other country will apply and this in turn will require that the enterprise is in a position to understand the differences between the rules governing financial reporting in the foreign country as compared to its own country of origin.

   Therefore, translation and reinstatements are of utmost importance in a world that is rapidly globalising in all ways. Further, the ASs and principles need to be robust so that the larger society develops degree of confidence in the financial statements, which are put forward by organisations.

2. **Comparability of Financial Statements:**

   International analysts and investors would like to compare financial statements based on similar ASs, and this has led to the growing need for an internationally accepted set of ASs for cross-border filings. The harmonization of financial reporting around the world will help to raise confidence of investors, generally, in the information they are using to make their decisions and assess their risks.

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3. **Uniformity, Comparability Transparency etc.:**

   A strong need was felt by legislation to bring about uniformity, rationalisation, comparability, transparency and adaptability in financial statements. Having a multiplicity of types of ASs around the world is against the public interest. If accounting for the same events and information produces different reported numbers, depending on the system of standards that are being used, then it is self-evident that accounting will be increasingly discredited in the eyes of those using the numbers. It creates confusion, encourages error and may facilitate fraud. The cure for these ills is to have a single set of global standards, of the highest quality, set in the interest of public. Global Standards facilitate cross border flow of money, global listing in different stock markets and comparability of financial statements.

4. **Global Investment:**

   The convergence of financial reporting and ASs is a valuable process that contributes to the free flow of global investment and achieves substantial benefits for all capital market stakeholders. It improves the ability of investors to compare investments on a global basis and, thus, lower their

risk of errors of judgment. It facilitates accounting and reporting for companies with global operations and eliminates some costly requirements like reinstatement of financial statements. It has the potential to create a new standard of accountability and greater transparency provides value to all market participants including regulators. It reduces operational challenges for accounting firms and focuses their values and expertise around an increasingly unified set of standards. It creates an unprecedented opportunity for standard setters and other stakeholders to improve the reporting model. For the companies with joint listings in both domestic and foreign country, the convergence is very much significant.

6. INTERNATIONAL ACCOUNTING STANDARD BOARD (IASB)

With a view of achieving the objective of setting global standards, the London based group namely the International Accounting Standards Committee (IASC), responsible for developing International Accounting Standards (IAS), was established in June, 1973. It is presently known as International Accounting Standards Board (IASB), The IASC comprises the professional accountancy bodies of over 75 countries (including the ICAI). Primarily, the IASC was established, in the public interest, to formulate and publish, IASs to be followed in the preparation and presentation of financial statements. IASs were issued to promote acceptance and observance of IASs worldwide. The members of IASC undertook a responsibility to support the standards developed by IASC and to propagate those standards in their respective countries.

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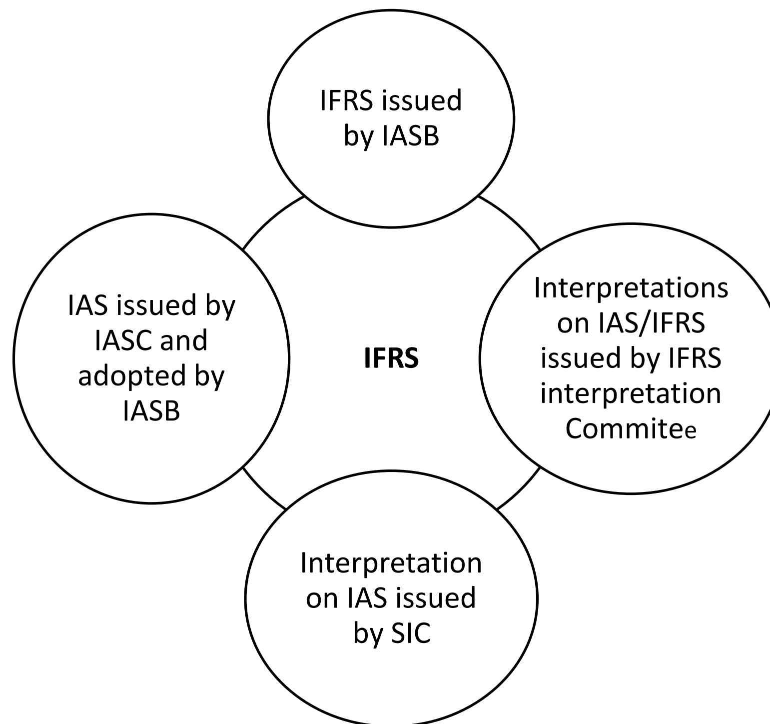
Between 1973 and 2001, the IASC released IASs. Between 1997 and 1999, the IASC restructured their organisation, which resulted in formation of IASB. These changes came into effect on 1st April, 2001. Subsequently, IASB issued statements about current and future standards. IASB publishes its Standards in a series of pronouncements called International Financial Reporting Standards (IFRS). However, IASB has not rejected the standards issued by the IASC. Those pronouncements continue to be designated as “International Accounting Standards” (IAS).

The standards issued by IASC till 31.03.2001 are known as IASs and the standards issued by IASB since 01.04.2001 are known as IFRSs.

7. INTERNATIONAL FINANCIAL REPORTING STANDARDS (IFRS) AS GLOBAL STANDARDS



The term International Financial Reporting Standards (IFRS) comprises:

1. IFRS issued by IASB;
2. IAS issued by IASC;
3. Interpretations issued by the Standard Interpretations Committee (SIC); and
4. Interpretations issued by the IFRS Interpretations Committee of the IASB (called IFRIC – International Financial Reporting Standards Interpretation Committee).

IFRSs are considered as a "principles-based" set of standards. In fact, they establish broad rules rather than dictating specific treatments. Every major nation is moving toward adopting them to some extent. Large number of authorities permits public companies to use IFRS for stock-exchange listing purposes, and in addition, banks, insurance companies and stock exchanges may use them for their statutorily required reports. So, over the next few years, number of companies will adopt the international standards. This requirement will affect thousands of enterprises, including their subsidiaries, equity investors and joint venture partners. The increased use of IFRS is not limited to public-companies listing requirements or statutory reporting. Many lenders and regulatory and government bodies are looking to IFRS to fulfil local financial reporting obligations related to financing or licensing.

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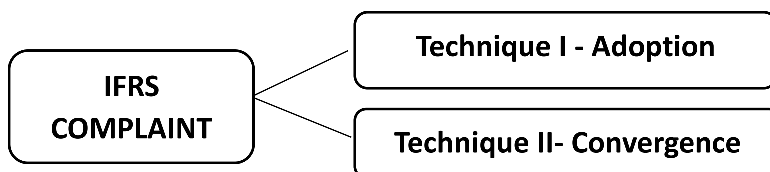
8. BECOMING IFRS COMPLIANT

Any country can become IFRS compliant either by adoption process or by convergence process.



Technique I – Adoption Process:

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

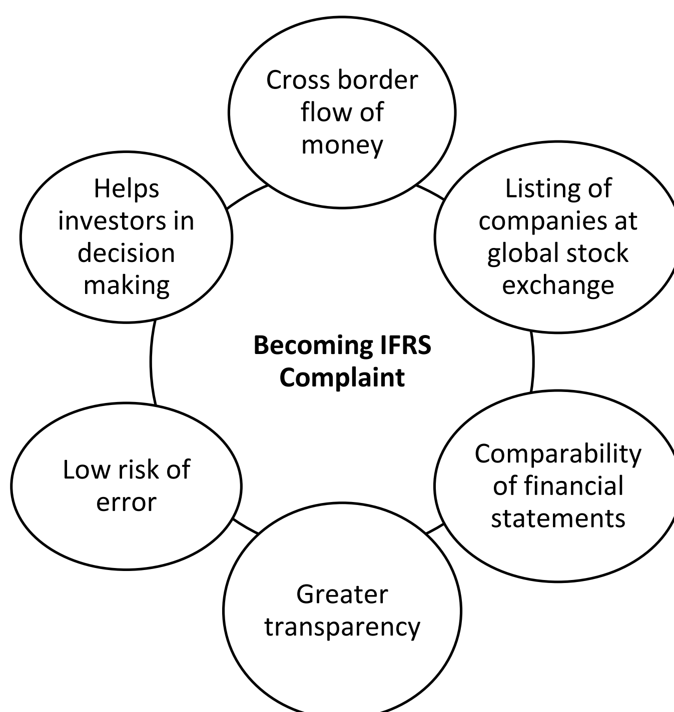
Technique II – Convergence Process:

Convergence means that the country will develop high quality, compatible accounting standards and there would be alignment of the standards of different standard setters with a certain rate of compromise, by adopting the requirements of the standards either fully or partially.

Ind AS are almost similar to IFRS but with few carve outs so as to make them suitable for Indian Environment.

Convergence with IFRS will result in following benefits:

- Improves investor confidence across the world with transparency and comparability
- Improves inter-unit/ inter-firm/inter-industry comparison
- Group consolidation will be easy with same standard by all companies in group irrespective of their global location.
- Acceptability of financial statements by stock exchanges across the globe, which will facilitate listing of Indian companies to international stock exchanges.



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9. WHAT ARE CARVE OUTS/INS IN IND AS?

The Government of India in consultation with the ICAI decided to converge and not to adopt IFRS issued by the IASB. The decision of convergence rather than adoption was taken after the detailed analysis of IFRS requirements and extensive discussion with various stakeholders.

Accordingly, while formulating Ind AS, efforts have been made to keep these Standards, as far as possible, in line with the corresponding IAS/IFRS and departures have been made where considered absolutely essential. These changes have been made considering various factors, such as:

- **Terminology differences:**

  Various terminology related changes have been made to make it consistent with the terminology used in law, e.g., 'statement of profit and loss' in place of 'statement of comprehensive income' (SOCI) and 'balance sheet' in place of 'statement of financial position' (SOFP).

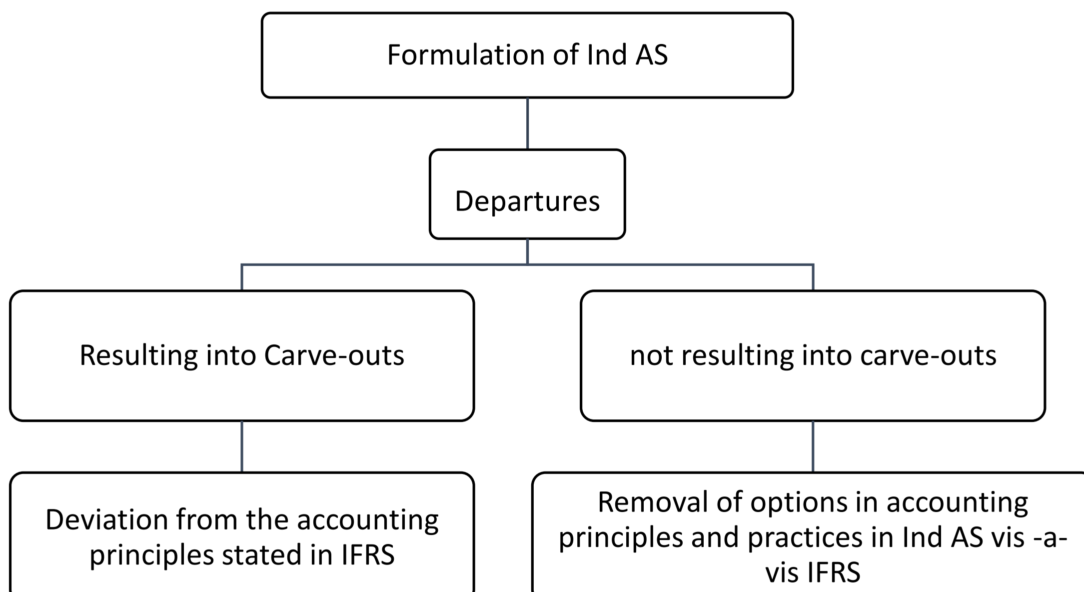
- **Removal of options in accounting principles and practices:**

  Removal of options in accounting principles and practices in Ind AS vis-a-vis IFRS, have been made to maintain consistency and comparability of the financial statements to be prepared by following Ind AS. However, these changes will not result into carve outs.

- **Difference in economic environment:**

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

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



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10. CONVERGENCE TO IFRS IN INDIA

In the scenario of globalisation, India cannot isolate itself from the accounting developments taking place worldwide. In India, so far as the ICAI, NFRA and various regulators such as SEBI and Reserve Bank of India (RBI) are concerned, the aim is to comply with the IFRS to the extent possible with the objective to formulate sound financial reporting standards for the purpose of preparing globally accepted financial statements. The ICAI, being a member of the International Federation of Accountants (IFAC), considered the IFRS and tried to integrate them, to the extent possible, in the light of the laws, customs, practices and business environment prevailing in India.

Due to the recent stream of overseas acquisitions by Indian companies, there is need for adoption of high-quality standards to convince foreign enterprises about the financial standing as also the disclosure and governance standards of Indian acquirers.

In India, the ICAI has worked towards convergence of global accounting standards by considering the application of IFRS in Indian corporate environment.

Recognising the growing need of full convergence of Ind AS with IFRS, ICAI constituted a Task Force to examine various issues involved.

Full convergence involves adoption of IFRS in the same form as that issued by the IASB.

For convergence of Ind AS with IFRS, the ASB in consultation with the MCA, decided that there will be two separate sets of accounting standards viz. (i) Ind AS converged with the IFRS – standards which are being converged by eliminating the differences of the Ind AS vis-à-vis IFRS and (ii) Existing notified AS.

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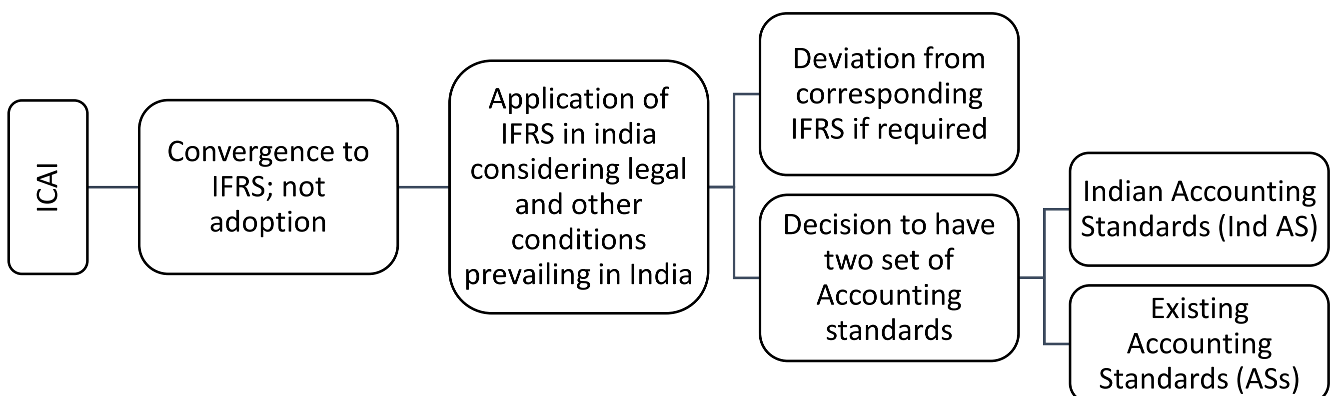

11. WHAT ARE INDIAN ACCOUNTING STANDARDS (IND AS)?

Ind AS are IFRS converged standards issued by the Central Government of India under the supervision and control of ASB of ICAI and in consultation with NFRA.

NFRA recommends these standards to the MCA. MCA has to spell out the accounting standards applicable for companies in India.

Ind AS are named and numbered in the same way as the corresponding IAS. However, for Ind AS corresponding to IFRS, one need to add 100 to the IFRS number e g. for IFRS 1 corresponding Ind AS number is 101.

Indian Accounting Standards			
Globalization and Liberalization	Transparency of financial statements	Comparability of financial statements	Enhanced Disclosure requirements

12. HISTORY OF IFRS-CONVERGED INDIAN ACCOUNTING STANDARDS (IND AS)

First Step towards IFRS

The ICAI being the accounting standards-setting body in India, way back in 2006, initiated the process of moving towards the IFRS issued by the IASB with a view to enhance acceptability and transparency of the financial information communicated by the Indian corporates through their financial statements. This move towards IFRS was subsequently accepted by the Government of India.

Government of India - Commitment to IFRS Converged Ind AS

As per the original roadmap for implementation of IFRS-converged Ind AS issued by the Government of India, initially Ind AS were expected to be implemented from the year 2011. However, keeping in view the fact that certain issues including tax issues were still to be addressed, the Ministry of Corporate Affairs decided to postpone the date of implementation of Ind AS.

In July 2014, the Finance Minister of India at that time, Late Shri Arun Jaitley Ji, in his Budget Speech, announced an urgency to converge the existing accounting standards with the IFRS through adoption of the Ind AS by the Indian companies.

Pursuant to the above announcement, various steps have been taken to facilitate the implementation of IFRS-converged Ind AS. Moving in this direction, the MCA issued the Companies (Indian Accounting Standards) Rules, 2015 vide Notification dated February 16, 2015 covering the revised roadmap of implementation of Ind AS for companies other than Banking companies, Insurance Companies and NBFCs and Ind AS.

As per the Notification, Ind AS converged with IFRS were required to be implemented on voluntary basis from 1st April, 2015 and mandatorily from 1st April, 2016.

Separate roadmaps were prescribed for implementation of Ind AS to Banking, Insurance companies and NBFCs.

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13. LIST OF IND AS

The following is the list of notified Ind AS vis-a-vis IFRS and AS:

Ind AS	IAS/ IFRS	Title of Ind AS / IFRS	AS / GN	AS / GN Title
101	IFRS 1	First Time Adoption of Indian Accounting Standards	-	-
102	IFRS 2	Share Based Payment	GN	Guidance Note on Accounting for Share-based Payments
103	IFRS 3	Business Combinations	AS 14	Accounting for Amalgamations
104	IFRS 4	Insurance Contracts	-	-
105	IFRS 5	Non-current Assets Held for Sale and Discontinued Operations	AS 24	Discontinuing Operations
106	IFRS 6	Exploration for and Evaluation of Mineral Resources	GN 15	Guidance Note on Accounting for Oil and Gas Producing Activities
107	IFRS 7	Financial Instruments: Disclosures	-	-
108	IFRS 8	Operating Segments	AS 17	Segment Reporting
109	IFRS 9	Financial Instruments	-	-
110	IFRS 10	Consolidated Financial Statements	AS 21	Consolidated Financial Statements
111	IFRS 11	Joint Arrangements	AS 27	Financial Reporting of Interests in Joint Ventures
112	IFRS 12	Disclosure of Interests in Other Entities	-	-
113	IFRS 13	Fair Value Measurement	-	-
114	IFRS 14	Regulatory Deferral Accounts	GN	Accounting for Rate Regulated Activities
115	IFRS 15	Revenue from contracts with customers	AS 7 AS 9	Construction Contract Revenue Recognition
116	IFRS 16	Leases	AS 19	Leases
	IFRS 17	Insurance Contracts	-	-
1	IAS 1	Presentation of Financial Statements	AS 1	Disclosure of Accounting Policies

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2	IAS 2	Inventories	AS 2	Valuation of Inventories
7	IAS 7	Statement of Cash Flows	AS 3	Cash Flow Statements
8	IAS 8	Accounting Policies, Changes in Accounting Estimates and Errors	AS 5	Net Profit or Loss for the Period, Prior period Items and Changes in Accounting Policies
10	IAS 10	Events after the Reporting Period	AS 4	Contingencies and Events Occurring After the Balance Sheet date
12	IAS 12	Income Taxes	AS 22	Accounting for Taxes on Income
16	IAS 16	Property, Plant and Equipment	AS 10	Property, Plant and Equipment
19	IAS 19	Employee Benefits	AS 15	Employee Benefits
20	IAS 20	Accounting for Government Grants and Disclosure of Government Assistance	AS 12	Accounting for Government Grants
21	IAS 21	The Effects of Changes in Foreign Exchange Rates	AS 11	The Effects of Changes in Foreign Exchange Rates
23	IAS 23	Borrowing Costs	AS 16	Borrowing Costs
24	IAS 24	Related Party Disclosures	AS 18	Related Party Disclosures
27	IAS 27	Separate Financial Statements	-	-
28	IAS 28	Investment in Associates and Joint Ventures	AS 23	Accounting for Investment in Associates in Consolidated Financial Statements
29	IAS 29	Financial Reporting in Hyperinflationary Economies	-	-
32	IAS 32	Financial Instruments: Presentation	-	-
33	IAS 33	Earnings per Share	AS 20	Earnings per Share
34	IAS 34	Interim Financial Reporting	AS 25	Interim Financial Reporting
36	IAS 36	Impairment of Assets	AS 28	Impairment of Assets
37	IAS 37	Provisions, Contingent Liabilities and Contingent Assets	AS 29	Provisions, Contingent Liabilities and Contingent Assets
38	IAS 38	Intangible Assets	AS 26	Intangible Assets
40	IAS 40	Investment Property	AS 13	Accounting for Investments
41	IAS 41	Agriculture	-	-

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14. ROADMAP FOR IMPLEMENTATION OF INDIAN ACCOUNTING STANDARDS (IND AS): A SNAPSHOT

For Companies other than Banks, NBFCs and Insurance Companies

Phase I: 1st April 2015 or thereafter (with Comparatives): Voluntary Basis for any company (other than Banks, NBFCs and Insurance companies) and its holding, subsidiary, Joint venture (JV) or Associate Company.

1st April 2016: Mandatory Basis

a. Companies listed/in process of listing on Stock Exchanges in India or Outside India having net worth of INR 500 crore or more;

b. Unlisted Companies having net worth of INR 500 crore or more;

c. Parent, Subsidiary, Associate and JV of above.

Phase II: 1st April 2017: Mandatory Basis

a. All companies which are listed/or in process of listing on Stock Exchanges in India or outside India not covered in Phase I (other than companies listed on SME Exchanges);

b. Unlisted companies having net worth of INR 250 crore or more but less than INR 500 crore;

c. Parent, Subsidiary, Associate and JV of above.

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Special Points to Consider:-

- Companies listed on SME exchange are not required to apply Ind AS. Such companies shall continue to apply existing ASs unless they choose otherwise.
- Once Ind AS are applicable, an entity shall be required to follow the Ind AS for all the subsequent financial statements i.e. there is no looking back once the Ind AS are adopted by companies.
- Companies not covered by the above roadmap shall continue to apply Accounting Standards notified in Companies (Accounting Standards) Rules, 2006.

For Non-Banking Financial Companies (NBFCs), Scheduled Commercial Banks (Excluding RRBs) and Insurers/Insurance Companies and

Non-Banking Financial Companies (NBFCs)	
Phase I:	From 1st April, 2018 (with comparatives)
	• NBFCs (whether listed or unlisted) having net worth INR 500 crore or more
	• Holding, Subsidiary, JV and Associate companies of above NBFC other than those already covered under corporate roadmap shall also apply from said date.
Phase II:	From 1st April, 2019 (with comparatives)
	• NBFCs whose equity and/or debt securities are listed or are in the process of listing on any stock exchange in India or outside India and having net worth less than INR 500 crore

	• NBFCs that are unlisted having net worth INR 250 crore or more but less than INR 500 crore
	• Holding, Subsidiary, JV and Associate companies of above companies other than those already covered under corporate roadmap shall also apply Ind AS from the said date.
➢ Applicable to both Consolidated and Individual Financial Statements	
➢ NBFC having net worth below INR 250 crore and not covered under the above provisions shall continue to apply ASs specified in Annexure to Companies (Accounting Standards) Rules, 2006.	
➢ Adoption of Ind AS is allowed only when required as per the roadmap.	
➢ Voluntary adoption of Ind AS is not allowed.	
Scheduled Commercial banks (excluding RRBs)	
➢ Scheduled Commercial Banks (SCBs) excluding Regional Rural Banks (RRBs) were initially required to implement Ind AS from 1 April 2018. However, RBI (Reserve Bank of India) vide a press release dated 5 April 2018, deferred the implementation of Ind AS by one year i.e. to be effective from 1 April 2019 instead of 1 April 2018. ➢ Further, the RBI through a notification dated 22 March 2019, deferred the Ind AS implementation till further notice. Urban Cooperative banks (UCBs) and Regional Rural banks (RRBs) are not required to apply Ind AS.	
Insurers/Insurance companies	
➢ MCA had outlined the road map for implementation of Ind AS by insurers/insurance companies from 1 April 2018. ➢ IRDAI (Insurance Regulatory and Development Authority of India) deferred the implementation of Ind AS in the insurance sector in India for a period of two years whereby the effective date was deferred to 1st April 2020. IRDAI, vide circular dated 21 January 2020, has deferred implementation of Ind AS in the insurance sector till further notice.	

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SUMMARY

The accounting standards aim at improving the quality of financial reporting by promoting comparability, consistency and transparency, in the interests of users of financial statements. The ICAI has, so far, issued 29 ASs. However, AS 6 on 'Depreciation Accounting' was withdrawn on revision of AS 10 'Property, Plant and Equipment and AS 8 on 'Accounting for Research and Development' has been withdrawn consequent to the issuance of AS 26 on 'Intangible Assets'. Thus, there are 27 ASs at present.

In the scenario of globalisation, India cannot isolate itself from the developments taking place worldwide. In India, so far as the ICAI and the Government authorities and various regulators such as SEBI and RBI are concerned, the aim has always been to comply with the IFRS to the extent possible with the objective of formulating sound financial reporting standards. Ind AS are IFRS converged standards issued by the Central Government of India under the supervision and control of ASB of ICAI and in consultation with NFRA.

As per the MCA Notification dated 16th February 2015, Ind AS converged with IFRS shall be implemented on voluntary basis from 1st April, 2015 and mandatorily from 1st April, 2016.

Separate roadmaps have been prescribed for implementation of Ind AS in Banking companies, Insurance companies and NBFCs.

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TEST YOUR KNOWLEDGE

MCQs

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

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

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

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

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

ANSWERS/HINTS

MCQs

1.	**c.**	Institute of Chartered Accountants of India
2.	**c.**	Both (a) and (b).
3.	**d.**	All the above.
4.	**b.**	MCA.
5.	**d.**	All the three.

THEORETICAL QUESTIONS

Q.NO.1. Explain the objective of "Accounting Standards" in brief. State the advantages of setting Accounting Standards.

ANSWER

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

Following are the objectives of Accounting Standards:

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

b. Accounting Standards facilitates the preparation of financial statements and make them comparable.

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

The main advantage of setting accounting standards are as follows:

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

b. Accounting Standards prevent any misleading accounting treatment.

c. Accounting Standards prevent manipulation of data by the management.

Q.NO.2. Briefly explain the process of issuance of Indian Accounting Standards.

ANSWER

Due to the recent stream of overseas acquisitions by Indian companies, there is need for adoption of high-quality standards to convince foreign enterprises about the financial standing as also the disclosure and governance standards of Indian acquirers.

The Government of India in consultation with the ICAI decided to converge and not to adopt IFRSs issued by the IASB. The decision of convergence rather than adoption was taken after the detailed analysis of IFRSs requirements and extensive discussion with various stakeholders.

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The ICAI has worked towards convergence of global accounting standards by considering the application of IFRS in Indian corporate environment. Recognising the growing need of full convergence of Ind AS with IFRS, ICAI constituted a Task Force to examine various issues involved. Ind AS are issued by the Central Government of India under the supervision and control of ASB of ICAI and in consultation with NFRA. NFRA recommends these standards to the MCA and MCA has to spell out the accounting standards applicable for companies in India.

Q.NO.3. Explain the significance of emergence of IFRS as Global Standards.

ANSWER

Global Standards facilitate cross border flow of money, global listing in different bourses and comparability of financial statements. Global Standards improve the ability of investors to compare investments on a global basis and thus lowers their risk of errors of judgment. It facilitates accounting and reporting for companies with global operations and eliminates some costly requirements say reinstatement of financial statements.

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Q.NO.4. What do you mean by Carve outs/ins in Ind AS? Explain.

ANSWER

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

2. FRAMEWORK FOR PREPARATION AND PRESENTATION OF FINANCIAL STATEMENTS

LEARNING OUTCOMES

After studying this chapter, you will be able to:

- Understand the meaning and significance of Framework for the Preparation and Presentation of Financial Statements;
- Learn objectives of Financial Statements
- Understand qualitative characteristics of Financial Statements;
- Comprehend recognition and measurement of elements of Financial Statements;
- Know concepts of capital, capital maintenance and determination of profit.

1. INTRODUCTION

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

The principal areas covered by the framework are as follows:

a. Components of financial statements;

b. Objectives of financial statements;

c. Assumptions underlying financial statements;

d. Qualitative characteristics of financial statements;

e. Elements of financial statements;

f. Criteria for recognition of elements in financial statements;

g. Principles for measurement of financial elements;

h. Concepts of Capital and Capital Maintenance.

2. PURPOSE OF THE FRAMEWORK

The framework sets out the concepts underlying the preparation and presentation of general-purpose financial statements prepared by enterprises for external users. The main purpose of the framework is to assist:

a. Enterprises in preparation of their financial statements in compliance with Accounting Standards and in dealing with the topics not yet covered by any Accounting Standard,

b. ASB in its task of development and review of Accounting Standards,

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c. ASB in promoting harmonisation of regulations, Accounting Standards and procedures relating to the preparation and presentation of financial statements by providing a basis for reducing the number of alternative accounting treatments permitted by Accounting Standards,

d. Auditors in forming an opinion as to whether financial statements conform to the Accounting Standards,

e. Users in interpretation of financial statements,

f. those who are interested in the work of ASB with information about its approach to the formulation of Accounting Standards.

3. STATUS AND SCOPE OF THE FRAMEWORK

The framework applies to general-purpose financial statements (hereafter referred to as 'financial statements' usually prepared annually for external users, by all commercial, industrial and business enterprises, whether in public or private sector. The special purpose financial reports, for example computations prepared for tax purposes are outside the scope of the framework. Nevertheless, the framework may be applied in preparation of such reports, to the extent not inconsistent with their requirements.

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

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4. COMPONENTS OF FINANCIAL STATEMENTS

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

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

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

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

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

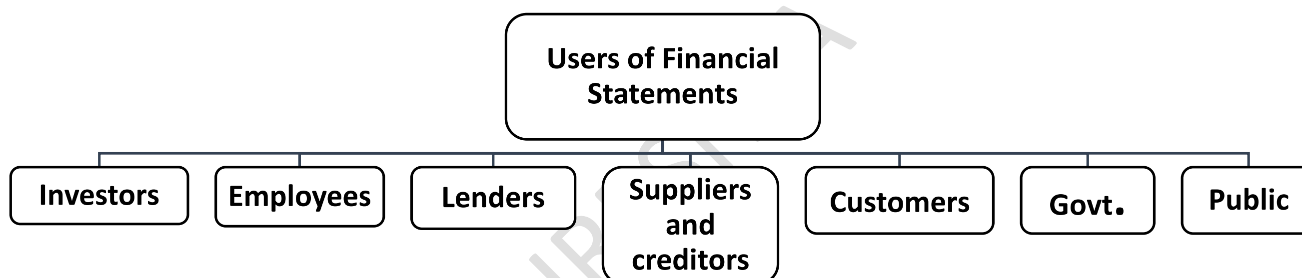
Cash Flow Statement shows the way an enterprise has generated cash and the way they have been used in an accounting period and helps in evaluating the investing, financing and operating activities during the reporting period.

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

5. OBJECTIVES AND USERS OF FINANCIAL STATEMENTS

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

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



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

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

a. **Investors -** The providers of risk capital are concerned with the risk inherent in, and return provided by, their investments. They are also interested in information which enables them to assess the ability of the enterprise to pay dividends.

b. **Employees -** Employees and their representative groups are interested in information about the stability and profitability of their employers. They are also interested in information which enables them to assess the ability of the enterprise to provide remuneration, retirement benefits and employment opportunities.

c. **Lenders -** Lenders are interested in information which enables them to determine whether their loans, and the interest attaching to them, will be paid when due.

d. **Suppliers and other trade creditors -** Suppliers and other creditors are interested in information which enables them to determine whether amounts owing to them will be paid when due. Trade creditors are likely to be interested in an enterprise over a shorter period than lenders unless they are dependent upon the continuance of the enterprise as a major customer.

e. **Customers -** Customers have an interest in information about the continuance of an enterprise, especially when they have a long term involvement with, or are dependent on, the enterprise for their goods and services.

f. **Governments and their agencies -** Governments and their agencies are interested in the allocation of resources and, therefore, the activities of enterprises. They also require information in order to regulate the activities of enterprises and determine taxation policies, and to serve as the basis for determination of national income and similar statistics.

g. **Public -** Enterprises affect members of the public in a variety of ways. For example, enterprises may make a substantial contribution to the local economy in many ways including the number of people they employ and their patronage of local suppliers. Financial statements may assist the public by providing information about the trends and recent developments in the prosperity of the enterprise and the range of its activities.

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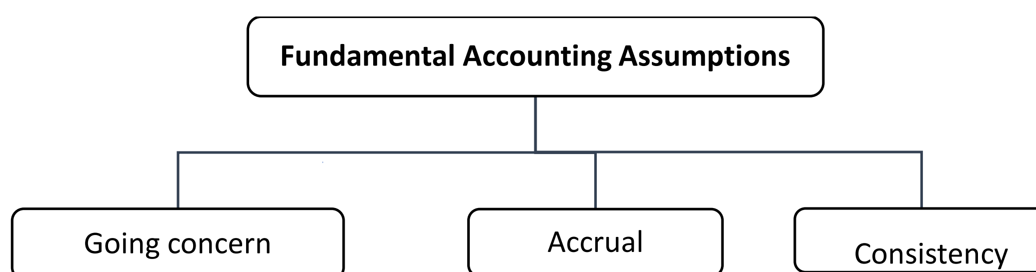
6. FUNDAMENTAL ACCOUNTING ASSUMPTIONS

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



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

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

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

Let us discuss these assumptions in detail.

a. Going Concern: Financial statements are normally prepared on the assumption that an enterprise will continue in operation in the foreseeable future and neither there is an intention, nor there is a need to materially curtail the scale of operations.

Financial statements prepared on going concern basis recognise among other things the need for sufficient retention of profit to replace assets consumed in operation and for making adequate provision for settlement of its liabilities. If any financial statement is prepared on a different basis, e.g. when assets of an enterprise are stated at net realisable values in its financial statements, the basis used should be disclosed.

(Refer Illustration 1)

b. Accrual Basis: According to AS 1, revenues and costs are accrued, that is, recognised as they are earned or incurred (and not as money is received or paid) and recorded in the financial statements of the periods to which they relate. Further Section 128(1) of the Companies Act, 2013 makes it mandatory for companies to maintain accounts on accrual basis only. It is not necessary to expressly state that accrual basis of accounting has been followed in preparation of a financial statement. In case, any income/ expense is recognised on cash basis, the fact should be stated.

Let's understand the impact of both approaches of accounting by way of an example.

Example 1

a. A trader purchased article A on credit in period 1 for Rs.50,000.

b. He also purchased article B in period 1 for Rs.2,000 cash.

c. The trader sold article A in period 1 for Rs.60,000 in cash.

d. He also sold article B in period 1 for Rs.2,500 on credit.

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

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Cash basis of accounting

Cash purchase of article B and cash sale of article A is recognised in period 1 while purchase of article A on payment and sale of article B on receipt is recognised in period 2.

Profit and Loss Account

		Rs.			**Rs.**
Period 1	To Purchase	2,000	Period 1	By Sale	60,000
	To Net Profit	58,000			
		60,000			60,000
Period 2	To Purchase	50,000	Period 2	By Sale	2,500
				By Net Loss	47,500
		50,000			50,000

Accrual basis of accounting

Credit purchase of article A and cash purchase of article B and cash sale of article A and credit sale of article B is recognised in period 1 only.

		Rs.			**Rs.**
Period 1	To Purchase	52,000	Period 1	By Sale	62,500
	To Net Profit	10,500			
		62,500			62,500

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

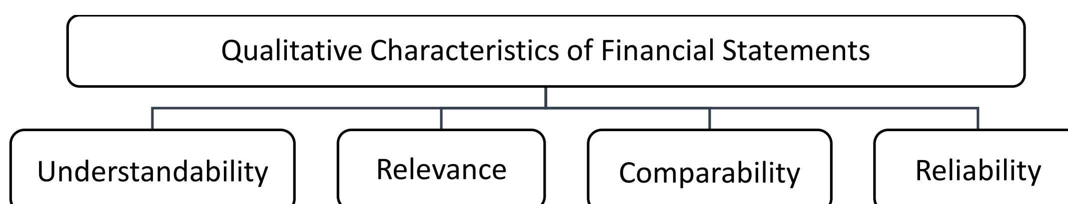
i. by a statute or

ii. by an Accounting Standard or

iii. for more appropriate presentation of financial statements.

7. QUALITATIVE CHARACTERISTICS OF FINANCIAL STATEMENTS

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



These attributes can be explained as:

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

   The financial statements should contain relevant information only. Information, which is likely to influence the economic decisions by the users, is said to be relevant. Such information may help the users to evaluate past, present or future events or may help in confirming or correcting past evaluations. The relevance of a piece of information should be judged by its materiality. A piece of information is said to be material if its misstatement (i.e., omission or erroneous statement) can influence economic decisions of a user taken on the basis of the financial information. Materiality depends on the size and nature of the item or error, judged in the specific circumstances of its misstatement. Materiality provides a threshold or cut-off point rather than being a primary qualitative characteristic which the information must have if it is to be useful.

   Further it is important to know the constraints also on Relevant and Reliable Information to better understand the qualitative characteristics of financial statements. Following are some of the constraints:

   a. **Timeliness**

      If there is undue delay in the reporting of information it may lose its relevance. Management may need to balance the relative merits of timely reporting and the provision of reliable information. To provide information on a timely basis it may often be necessary to report before all aspects of a transaction or other event are known, thus impairing reliability. Conversely, if reporting is delayed until all aspects are known, the information may be highly reliable but of little use to users who have had to make decisions in the interim. In achieving a balance between relevance and reliability, the overriding consideration is how best to satisfy the information needs of users.

   b. **Balance between Benefit and Cost**

      The balance between benefit and cost is a pervasive constraint rather than a qualitative characteristic. The benefits derived from information should exceed the cost of providing it. The evaluation of benefits and costs is, however, substantially a judgmental process. The preparers and users of financial statements should be aware of this constraint.

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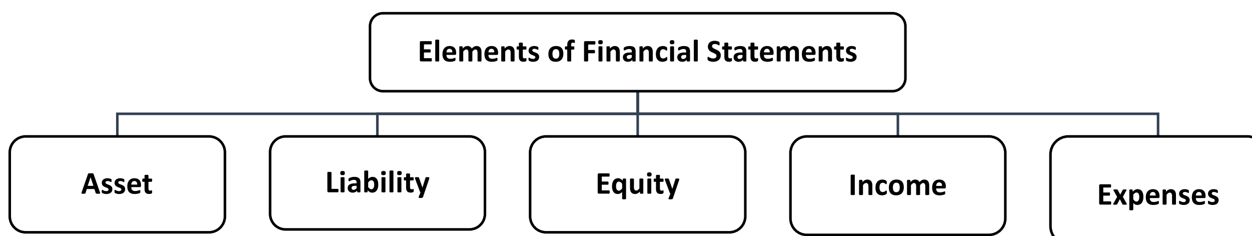
3. **Reliability:** To be useful, the information must be reliable; that is to say, they must be free from material error and bias. The information provided are not likely to be reliable unless:
   a. Transactions and events reported are faithfully represented.
   b. Transactions and events are reported on the principle of 'substance over form (discussed later in AS-1)'.
   c. The reporting of transactions and events are neutral, i.e. free from bias.
   d. Prudence is exercised in reporting uncertain outcome of transactions or events.
   e. The information in financial statements must be complete.
4. **Comparability:** Comparison of financial statements is one of the most frequently used and most effective tools of financial analysis. The financial statements should permit both inter-firm and intra-firm comparison. One essential requirement of comparability is disclosure of financial effect of change in accounting policies. However, the need for comparability should not be confused with mere uniformity and should not be allowed to become an impediment to the introduction of improved accounting standards. It is not appropriate for an enterprise to continue accounting in the same manner for a transaction or other event if the policy adopted is not in keeping with the qualitative characteristics of relevance and reliability. It is also inappropriate for an enterprise to leave its accounting policies unchanged when more relevant and reliable alternatives exist.

8. TRUE AND FAIR VIEW

Financial statements are required to show a true and fair view of the performance, financial position and cash flows of an enterprise. The framework does not deal directly with this concept of true and fair view, yet application of the principal qualitative characteristics and appropriate accounting standards normally results in financial statements portraying true and fair view of information about an enterprise.

9. ELEMENTS OF FINANCIAL STATEMENTS

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



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Gains and losses differ from income and expenses in the sense that they may or may not arise in the ordinary course of business. Except for the way they arise, economic characteristics of gains are same as income and those of losses are same as expenses. For these reasons, gains and losses are not recognised as separate elements of financial statements.

Let us discuss each element of financial statement in detail.

1. **Asset:** An asset is a resource controlled by the enterprise as a result of past events from which future economic benefits are expected to flow to the enterprise. The following points must be considered while recognising an asset:
   - **a.** The resource regarded as an asset, need not have a physical substance. The resource may represent a right generating future economic benefit, e.g. patents, copyrights, trade receivables. An asset without physical substance can be either intangible asset, e.g. patents and copyrights or monetary assets, e.g. trade receivables. The monetary assets are money held and assets to be received in fixed or determinable amounts of money.
   - **b.** An asset is a resource controlled by the enterprise. This means it is possible to recognise a resource not owned but controlled by the enterprise as an asset, i.e., legal ownership may or may not vest with the enterprise. Such is the case of financial lease, where lessee recognises the asset taken on lease, even if ownership lies with the lessor. Likewise, the lessor does not recognise the asset given on finance lease as asset in his books, because despite of ownership, he does not control the asset.
   - **c.** A resource cannot be recognised as an asset if the control is not sufficient. For this reason specific management or technical talent of an employee cannot be recognised because of insufficient control. When the control over a resource is protected by a legal right, e.g. copyright, the resource can be recognised as an asset.
   - **d.** To be considered as an asset, it must be probable that the resource generates future economic benefits. If the economic benefits from a resource is expected to expire within the current accounting period, it is not an asset. For example, economic benefits, i.e. profit on sale, from machinery purchased by an enterprise who deals in such kind of machinery is expected to expire within the current accounting period. Such purchase of machinery is therefore booked as an expense rather than capitalised in the machinery account. However, if the articles purchased by a dealer remain unsold at the end of accounting period, the unsold items are recognised as assets, i.e. closing stock, because the sale of the article and resultant economic benefit, i.e. profit is expected to be earned in the next accounting period.

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e. To be considered as an asset, the resource must have a cost or value that can be measured reliably.

f. When flow of economic benefit to the enterprise beyond the current accounting period is considered improbable, the expenditure incurred is recognised as an expense rather than as an asset.

2. **Liability:** A liability is a present obligation of the enterprise arising from past events, the settlement of which is expected to result in an outflow of a resource embodying economic benefits. The following points may be noted:

   a. A liability is a present obligation, i.e. an obligation the existence of which, based on the evidence available on the balance sheet date is considered probable. For example, an enterprise may have to pay compensation if it loses a damage suit filed against it. The damage suit is pending on the balance sheet date. The enterprise should recognise a liability for damages payable by a charge against profit if it is probable that the enterprise will lose the suit and if the amount of damages payable can be ascertained with reasonable accuracy. The enterprise should create a provision for damages payable by charge against profit, if probability of losing the suit is more than not losing it and if the amount of damages payable can be ascertained with reasonable accuracy. In other cases, the company reports the damages payable as 'contingent liability', which does not meet the definition of liability. Accounting standards define provision as a liability, which can be measured only by using a substantial degree of estimation.

   b. It may be noted that certain provisions, e.g. provisions for doubtful debts, depreciation and impairment losses, represent diminution in value of assets rather than obligations. These provisions should not be considered as liability.

   c. A liability is recognised only when outflow of economic resources in settlement of a present obligation can be anticipated and the value of outflow can be reliably measured. Otherwise, the liability is not recognised. For example, liability cannot arise on account of future commitment. A decision by the management of an enterprise to acquire assets in the future does not, of itself, give rise to a present obligation. An obligation normally arises only when the asset is delivered or the enterprise enters into an irrevocable agreement to acquire the asset.

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Example 2

A Ltd. has entered into a binding agreement with P Ltd. to buy a custom-made machine for Rs.40,000. At the end of 20X1-X2, before delivery of the machine, A Ltd. had to change its method of production. The new method will not require the machine ordered and it will be scrapped after delivery. The expected scrap value is nil.

A liability is recognised when outflow of economic resources in settlement of a present obligation can be anticipated and the value of outflow can be reliably measured. In the given case, A Ltd. should recognise a liability of Rs.40,000 to P Ltd.

When flow of economic benefit to the enterprise beyond the current accounting period is considered improbable, the expenditure incurred is recognised as an expense rather than as an asset. In the present case, flow of future economic benefit from the machine to the enterprise is improbable. The entire amount of purchase price of the machine should be recognised as an expense. The accounting entry is suggested below:

Particulars		Rs.	Rs.
Loss on change in production Method To P Ltd. (Loss due to change in production method)	Rd.	40,000	40,000
Profit and loss A/c To Loss on change in production method (loss transferred to profit and loss account)	Rd.	40,000	40,000

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3. **Equity:** Equity is defined as residual interest in the assets of an enterprise after deducting all its liabilities. It is important to avoid mixing up liabilities with equity. Equity is the excess of aggregate assets of an enterprise over its aggregate liabilities. In other words, equity represents owners' claim consisting of items like capital and reserves, which are clearly distinct from liabilities, i.e. claims of parties other than owners. The value of equity may change either through contribution from / distribution to equity participants or due to income earned /expenses incurred.

4. **Income:** Income is increase in economic benefits during the accounting period in the form of inflows or enhancement of assets or decreases in liabilities that result in increase in equity other than those relating to contributions from equity participants. The definition of income encompasses revenue and gains. Revenue is an income that arises in the ordinary course of activities of the enterprise, e.g. sales by a trader. Gains are income, which may or may not arise in the ordinary course of activity of the enterprise, e.g. profit on disposal of Property,

Plant and Equipment. Gains are showed separately in the statement of profit and loss because this knowledge is useful in assessing performance of the enterprise.

Income earned is always associated with either increase of asset or reduction of liability. This means, no income can be recognised unless the corresponding increase of asset or decrease of liability can be recognised. For example, a bank does not recognise interest earned on non-performing assets because the corresponding asset (increase in advances) cannot be recognised, as flow of economic benefit to the bank beyond current accounting period is not probable.

Thus

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

A – L = E.

Where:

A = Aggregate value of asset

L = Aggregate value of liabilities

E = Aggregate value of equity

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Example 3

Suppose at the beginning of an accounting period, aggregate values of assets, liabilities and equity of a trader are Rs. 5 lakh, Rs. 2 lakh and Rs. 3 lakh respectively. Also suppose that the trader had the following transactions during the accounting period.

a. Introduced capital Rs. 20,000.

b. Earned income from investment Rs. 8,000.

c. A liability of Rs. 31,000 was finally settled on payment of Rs. 30,000.

Balance sheets of the trader after each transaction are shown below:

Transactions	Assets Rs. lakh	–	Liabilities Rs. lakh	=	Equity Rs. lakh
Opening	5.00	–	2.00	=	3.00
a. Capital introduced	5.20	–	2.00	=	3.20
b. Income from investments	5.28	–	2.00	=	3.28
c. Settlement of liability	4.98	–	1.69	=	3.29

The example given above explains the definition of income. The equity increased by Rs.29,000 during the accounting period, due to (i) Capital introduction Rs.20,000 and (ii) Income earned Rs.9,000 (Income from investment + Discount earned). Incomes therefore result in increase in equity without introduction of capital.

Also note that income earned is accompanied by either increase of asset (Cash received as investment income) or by decrease of liability (Discount earned).

5. **Expense:** An expense is decrease in economic benefits during the accounting period in the form of outflows or depletions of assets or incurrence of liabilities that result in decrease in equity other than those relating to distributions to equity participants. The definition of expenses encompasses expenses that arise in the ordinary course of activities of the enterprise, e.g. wages paid. Losses may or may not arise in the ordinary course of activity of the enterprise, e.g. loss on disposal of Property, Plant and Equipment. Losses are separately shown in the statement of profit and loss because this knowledge is useful in assessing performance of the enterprise.

   Expenses are always incurred simultaneously with either reduction of asset or increase of liability. Thus, expenses are recognised when the corresponding decrease of asset or increase of liability are recognised by application of the recognition criteria stated above. Expenses are recognised in Profit & Loss A/c by matching them with the revenue generated. However, application of matching concept should not result in recognition of an item as asset (or liability), which does not meet the definition of asset or liability as the case may be.

   Where economic benefits are expected to arise over several accounting periods, expenses are recognised in the profit and loss statement on the basis of systematic and rational allocation procedures. The obvious example is that of depreciation.

   An expense is recognised immediately in the profit and loss statement when it does not meet or ceases to meet the definition of asset or when no future economic benefit is expected. An expense is also recognised in the profit and loss statement when a liability is incurred without recognition of an asset, as is the case when a liability under a product warranty arises.

Example 4

Continuing with the example 3 given earlier, suppose the trader had the following further transactions during the period:

a. Wages paid Rs. 2,000.

b. Rent outstanding Rs. 1,000.

c. Drawings Rs. 4,000.

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Balance sheets of the trader after each transaction are shown below:

Transactions	Assets Rs. lakh	–	Liabilities Rs. lakh	=	Equity Rs. Lakh
Opening	5.00	–	2.00	=	3.00
a. Capital introduced	5.20	–	2.00	=	3.20
b. Income from investments	5.28	–	2.00	=	3.28
c. Settlement of liability	4.98	–	1.69	=	3.29
d. Wages paid	4.96	–	1.69	=	3.27
e. Rent Outstanding	4.96	–	1.70	=	3.26
f. Drawings	4.92	–	1.70	=	3.22

The example given above explains the definition of expense. The equity decreased by Rs. 7,000 from Rs. 3.29 lakh to Rs. 3.22 lakh due to (i) Drawings Rs. 4,000 and (ii) Expenses incurred Rs. 3,000 (Wages paid + Rent).

Expenses therefore result in decrease of equity without drawings. Also note that expenses incurred is accompanied by either decrease of asset (Cash paid for wages) or by increase in liability (Rent outstanding).

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Note: The points discussed above leads us to the following relationships:

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

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

Capital Introduced = C

Drawings = D

Income = I

Expenses = E

CE= OE + C + (I – E) – D

Or CE = OE + C + Profit – D

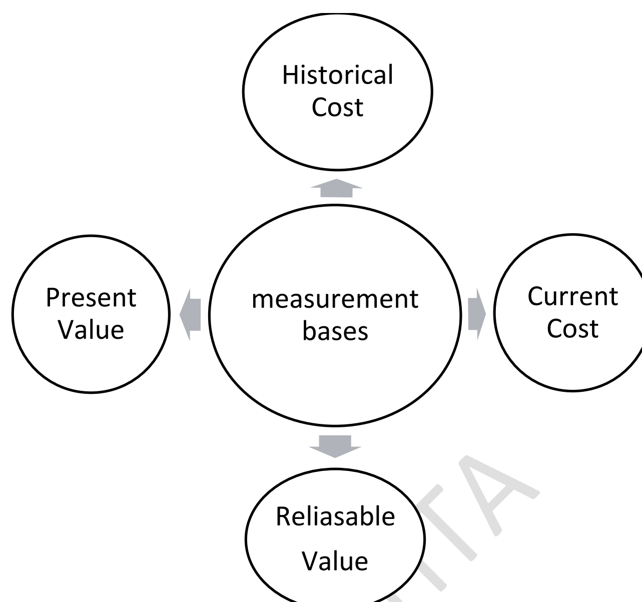
Or Profit = CE – OE – C + D

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

From above, one can clearly see that profit depends on values of assets and liabilities. Since historical costs are mostly used for valuation, the reported profits are mostly based on historical cost conventions. The framework recognises other methods of valuation of assets and liabilities. The point to note is that reported figures of profit change with the changes in the valuation basis. Conceptually, this is the foundation of idea of Capital Maintenance.

10. MEASUREMENT OF ELEMENTS OF FINANCIAL STATEMENTS

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



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In preparation of financial statements, all or any of the measurement basis can be used in varying combinations to assign money values to items, subject to the requirements under the Accounting Standards. However, it may be noted, that Accounting Standards largely uses the 'historical cost' for the purpose of preparation of financial statements though for some items, use of other value is permitted, e.g., inventory is recorded at historical costs on its acquisition, however, at year end, it is valued at lower of costs and net realisable value.

A brief explanation of each measurement basis is as follows:

1. **Historical Cost:** Historical cost means acquisition price. For example, the businessman paid Rs.7,00,000 to purchase the machine, its acquisition price including installation charges is Rs.8,00,000. The historical cost of machine would be Rs.8,00,000.

   According to this, assets are recorded at an amount of cash or cash equivalent paid or the fair value of the asset at the time of acquisition. Liabilities are recorded at the amount of proceeds received in exchange for the obligation. In certain circumstances a liability is recorded at the amount of cash or cash equivalent expected to be paid to satisfy the obligation in the normal course of business.

When Mr. X, a businessman, takes Rs.5,00,000 loan from a bank @ 10% interest p.a., it is to be recorded at the amount of proceeds received in exchange for the obligation. Here the obligation is the repayment of loan as well as payment of interest at an agreed rate i.e. 10%. Proceeds received are Rs.5,00,000 - it is the historical cost of the transaction. Take another case regarding payment of income tax liability. You know that every individual has to pay income tax on his income if it exceeds certain minimum limit. But the income tax liability is not settled immediately when one earns his income. The income tax authority settles it sometime later, which is technically called assessment year. Then how does he record this liability? As per historical cost basis, it is to be recorded at an amount expected to be paid to discharge the liability.

Example 5

Mr. X purchased a machine on 1st January, 20X1 at Rs. 7,00,000. As per historical cost basis, he has to record it at Rs. 7,00,000 i.e., the acquisition price. As on 1.1.20X6, Mr. X found that it would cost Rs. 25,00,000 to purchase that machine. Mr. X also took loan from a bank as on 20X1 for Rs. 5,00,000 @ 18% p.a. repayable at the end of 15th year together with interest.

As per historical cost, the liability is recorded at Rs. 5,00,000 at the amount of proceeds received in exchange for obligation and asset is recorded at Rs. 7,00,000.

2. **Current Cost:** Current cost gives an alternative measurement basis. Assets are carried at the amount of cash or cash equivalent that would have to be paid if the same or an equivalent asset was acquired currently. Liabilities are carried at the undiscounted amount of cash or cash equivalents that would be required to settle the obligation currently.

Example 6

A machine was acquired for $ 10,000 on deferred payment basis. The rate of exchange on the date of acquisition was Rs. 49 per $. The payments are to be made in 5 equal annual instalments together with 10% interest per year. The current market value of similar machine in India is Rs. 5 lakhs.

Current cost of the machine = Current market price = Rs. 5,00,000.

By historical cost convention, the machine would have been recorded at Rs. 4,90,000.

To settle the deferred payment on current date one must buy dollars at Rs. 49/$. The liability is therefore recognised at Rs. 4,90,000 ($ 10,000 × Rs. 49). Note that the amount of liability recognised is not the present value of future payments. This is because, in current cost convention, liabilities are recognised at undiscounted amount.

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3. **Realisable (Settlement) Value:** For assets, this is the amount of cash or cash equivalents currently realisable on sale of the asset in an orderly disposal. For liabilities, this is the undiscounted amount of cash or cash equivalents expected to be paid on settlement of liability in the normal course of business.
4. **Present Value:** Assets are carried at the present value of the future net cash inflows that the item is expected to generate in the normal course of business. Liabilities are carried at the present value of the future net cash outflows that are expected to be required to settle the liabilities in the normal course of business.

   Present value (P) is an amount, one has to invest on current date to have an amount (A) after n years. If the rate of interest is R then,

   A = P(1 + R)n

   Or P (Present value of A after n years) = $\frac{A}{(1+r)^n} = A \times \frac{1}{(1+r)^n}$

The process of obtaining present value of future cash flow is called discounting. The rate of interest used for discounting is called the discounting rate. The expression [1/(1+R)n], called discounting factor which depends on values of R and n.

Let us take a numerical example assuming interest 10%, A = Rs. 11,000 and n = 1 year 11,000 = $10{,}000(1 + 0.1)^1$

Or Present value of Rs. 11,000 after 1 year = $= \frac{11{,}000}{(1.10)^1} = 11{,}000 \times \frac{1}{(1.10)^1}$

Or Present value of Rs. 11,000 after 1 year = 11,000 × 0.909 = Rs. 10,000

Note that a receipt of Rs. 10,000 (present value) now is equivalent of a receipt of Rs. 11,000 (future cash inflow) after 1 year, because if one gets Rs. 10,000 now he can invest to collect Rs. 11,000 after 1 year. Likewise, a payment of Rs. 10,000 (present value) now is equivalent of paying of Rs. 11,000 (future cash outflow) after 1 year.

Thus if an asset generates Rs. 11,000 after 1 year, it is actually contributing Rs. 10,000 at the current date if the rate of earning required is 10%. In other words, the value of the asset is Rs. 10, 000. which is the present value of net future cash inflow it generates.

If an asset generates Rs. 11,000 after 1 year, and Rs. 12,100 after two years, it is actually contributing Rs. 20,000 (approx.) at the current date if the rate of earning required is 10% (Rs. 11,000 × 0.909 + Rs. 12,100 × 0.826). In other words the value of the asset is Rs. 20,000(approx.), i.e. the present value of net future cash inflow it generates.

Under present value convention, assets are carried at present value of future net cash flows generated by the concerned assets in the normal course of business. Liabilities under this

convention are carried at present value of future net cash flows that are expected to be required to settle the liability in the normal course of business.

Example 7

Carrying amount of a machine is Rs. 40,000 (Historical cost less depreciation). The machine is expected to generate Rs. 10,000 net cash inflow. The net realisable value (or net selling price) of the machine on current date is Rs. 35,000. The enterprise's required earning rate is 10% per year. The enterprise can either use the machine to earn Rs. 10,000 for 5 years. This is equivalent of receiving present value of Rs. 10,000 for 5 years at discounting rate 10% on current date. The value realised by use of the asset is called value in use. The value in use is the value of asset by present value convention.

Value in use = Rs. 10,000 (0.909 + 0.826 + 0.751 + 0.683 + 0.621) = Rs. 37,900

Net selling price = Rs. 35,000

The present value of the asset is Rs. 37,900, which is called its recoverable value. It is obviously not appropriate to carry any asset at a value higher than its recoverable value. Thus the asset is currently overstated by Rs. 2,100 (Rs. 40,000 – Rs. 37,900).

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11. CAPITAL MAINTENANCE

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

We have already observed: P = (CA – CL) – (OA – OL) – C + D

Where: Profit = P

Opening Assets = OA and Opening Liabilities = OL

Closing Assets = CA and Closing Liabilities = CL

Introduction of capital = C and Drawings / Dividends = D

Retained Profit = P – D = (CA – CL) – (OA – OL) – C

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

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

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

Example 8

A trader commenced business on 01/01/20X1 with Rs. 12,000 represented by 6,000 units of a certain product at Rs. 2 per unit. During the year 20X1 he sold these units at Rs. 3 per unit and had withdrawn Rs. 6,000. Thus:

Opening Equity = Rs. 12,000 represented by 6,000 units at Rs. 2 per unit.

Closing Equity = Rs. 12,000 (Rs. 18,000 – Rs. 6,000) represented entirely by cash.

Retained Profit = Rs. 12,000 – Rs. 12,000 = Nil

The trader can start year 20X2 by purchasing 6,000 units at Rs. 2 per unit once again for selling them at Rs. 3 per unit. The whole process can repeat endlessly if there is no change in purchase price of the product.

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Financial capital maintenance at current purchasing power: Under this convention, opening and closing equity at historical costs are restated at closing prices using average price indices. (For example, suppose opening equity at historical cost is Rs. 3,00,000 and opening price index is 100. The opening equity at closing prices is Rs. 3,60,000 if closing price index is 120). A positive retained profit by this method means the business has enough funds to replace its assets at average closing price. This may not serve the purpose because prices of all assets do not change at average rate in real situations. For example, price of a machine can increase by 30% while the average increase is 20%.

Example 9

In the previous example 8, suppose that the average price indices at the beginning and at the end of year are 100 and 120 respectively.

Opening Equity = Rs. 12,000 represented by 6,000 units at Rs. 2 per unit.

Opening equity at closing price = (Rs. 12,000 / 100) x 120 = Rs. 14,400 (6,000 x Rs. 2.40)

Closing Equity at closing price

= Rs. 12,000 (Rs. 18,000 – Rs. 6,000) represented entirely by cash.

Retained Profit = Rs. 12,000 – Rs. 14,400 = (–) Rs. 2,400

The negative retained profit indicates that the trader has failed to maintain his capital. The available fund of Rs. 12,000 is not sufficient to buy 6,000 units again at increased price Rs. 2.40 per unit. In fact, he should have restricted his drawings to Rs. 3,600 (Rs. 6,000 – Rs. 2,400).
Had the trader withdrawn Rs. 3,600 instead of Rs. 6,000, he would have left with Rs. 14,400, the fund required to buy 6,000 units at Rs. 2.40 per unit.

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

(Refer Illustration 2)

SUMMARY

- **Components of Financial Statements**

Balance sheet	Portrays value of economics resources controlled by an enterprise
Statement of Profit and loss	Presents the results of operations of an enterprise
Cash flow statement	Shows the way an enterprise generates cash and uses it
Notes, other statements and other explanatory materials	Presents supplementary information explaining different items

- **Users of Financial Statements**

Investors	Analysis of performance, profitability, financial position of company
Employees	Knowledge of stability, continuity, growth
Suppliers, creditors	Determination of credit worthiness
Customers	Analysis of stability, profitability
Government	Evaluation of entity's performance and contribution to social objectives
Lenders	Determine whether their loans, and the interest attaching to them, will be paid when due
Public	Determine contribution to the local economy and public at large

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- **Fundamental Accounting Assumptions**

Accrual	Transactions are recognised as and when they occur, without considering receipt /payment of cash.
Going concern	Enterprise will continue in operation in foreseeable future and will not liquidate.
Consistency	Using same accounting policies for similar transactions in all accounting periods

- **Qualitative Characteristics of Financial Statements**

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

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- **Elements of Financial Statements**

Asset	Resource controlled by the enterprise as a result of past events from which future economic benefits are expected to flow to the enterprise
Liability	Present obligation of the enterprise arising from past events, the settlement of which is expected to result in an outflow of a resource embodying economic benefits.
Equity	Residual interest in the assets of an enterprise after deducting all its liabilities
Income/gain	Increase in economic benefits during the accounting period in the form of inflows or enhancement of assets or decreases in liabilities that result in increase in equity other than those relating to contributions from equity participants
Expense/loss	Decrease in economic benefits during the accounting period in the form of outflows or depletions of assets or incurrence of liabilities that result in decrease in equity other than those relating to distributions to equity participants

- **Measurement of Elements in Financial Statements**

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

- **Financial Capital Maintenance**

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

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ILLUSTRATIONS

Illustration 1

Balance sheet of a trader on 31st March, 20X1 is given below:

Liabilities	Rs.	Assets	Rs.
Capital	60,000	Property, Plant and Equipment	65,000
		Stock	30,000
Profit and Loss Account 10%	25,000	Trade receivables	20,000
Loan	35,000	Deferred expenditure	10,000
Trade payables	10,000	Bank	5,000
	1,30,000		1,30,000

Additional information:

a. The remaining life of Property, Plant and Equipment is 5 years. The pattern of use of the asset is even. The net realisable value of Property, Plant and Equipment on 31.03.X2 was Rs. 60,000.

b. The trader's purchases and sales in 20X1-X2 amounted to Rs. 4 lakh and Rs. 4.5 lakh respectively.

c. The cost and net realisable value of stock on 31.03.X2 were Rs. 32,000 and Rs. 40,000 respectively.

d. Expenses (including interest on 10% Loan of Rs. 3,500 for the year) amounted to Rs. 14,900.

e. Deferred expenditure is amortised equally over 4 years.

f. Trade receivables on 31.03.X2 is Rs. 25,000, of which Rs. 2,000 is doubtful. Collection of another Rs. 4,000 depends on successful re-installation of certain product supplied to the customer.

g. Closing trade payable is Rs. 12,000, which is likely to be settled at 5% discount.

h. Cash balance on 31.03.X2 is Rs. 37,100.

i. There is an early repayment penalty for the loan Rs. 2,500.

You are required to prepare Profit and Loss Accounts and Balance Sheets of the trader in both cases

i. assuming going concern

ii. not assuming going concern.

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Solution

Profit and Loss Account for the year ended 31st March, 20X2

	Case (i)	Case (ii)		Case (i)	Case (ii)
	Rs.	**Rs.**		**Rs.**	**Rs.**
To Opening Stock	30,000	30,000	By Sales	4,50,000	4,50,000
To Purchases	4,00,000	4,00,000	By Closing Stock	32,000	40,000
To Expenses	14,900	14,900	By Trade payables	–	600
To Depreciation	13,000	5,000			
To Provision for doubtful debts	2,000	6,000			
To Deferred expenditure	2,500	10,000			
To Loan penalty	–	2,500			
To Net Profit (b.f.)	19,600	22,200			
	4,82,000	**4,90,600**		**4,82,000**	**4,90,600**

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Balance Sheet as at 31st March, 20X2

Liabilities	Case (i) Rs.	Case (ii) Rs.	Assets	Case (i) Rs.	Case (ii) Rs.
Capital	60,000	60,000	Property, Plant and Equipment	52,000	60,000
Profit & Loss A/c	44,600	47,200	Stock	32,000	40,000
10% Loan	35,000	37,500	Trade Receivables (less provision)	23,000	19,000
			Deferred expenditure	7,500	Nil
Trade payables	12,000	11,400			
			Bank	37,100	37,100
	1,51,600	**1,56,100**		**1,51,600**	**1,56,100**

Illustration 2

A trader commenced business on 01/01/20X1 with Rs. 12,000 represented by 6,000 units of a certain product at Rs. 2 per unit. During the year 20X1 he sold these units at Rs. 3 per unit and had withdrawn Rs. 6,000. Let us assume that the price of the product at the end of year is Rs. 2.50 per unit. In other words, the specific price index applicable to the product is 125.

Current cost of opening stock = (Rs. 12,000 / 100) x 125 = 6,000 x Rs. 2.50 = Rs. 15,000

Current cost of closing cash = Rs. 12,000 (Rs. 18,000 – Rs. 6,000)

Opening equity at closing current costs = Rs. 15,000 Closing equity at closing current costs = Rs. 12,000 Retained Profit = Rs. 12,000 – Rs. 15,000 = (-) Rs. 3,000

The negative retained profit indicates that the trader has failed to maintain his capital. The available fund of Rs. 12,000 is not sufficient to buy 6,000 units again at increased price of Rs. 2.50 per unit. The drawings should have been restricted to Rs. 3,000 (Rs. 6,000 – Rs. 3,000). Had the trader withdrawn Rs. 3,000 instead of Rs. 6,000, he would have left with Rs.15,000, the fund required to buy 6,000 units at Rs. 2.50 per unit.

You are required to compute the Capital maintenance under all three bases ice.

i. **Historical costs,**
ii. **Current purchasing power and**
iii. **Physical capital maintenance.**

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Solution

Financial Capital Maintenance at historical costs

	Rs.	**Rs.**
Closing capital (At historical cost)		12,000
Less: Capital to be maintained		
Opening capital (At historical cost)	12,000	
Introduction (At historical cost)	Nil	(12,000)
Retained profit		Nil

Financial Capital Maintenance at current purchasing power

	Rs.	**Rs.**
Closing capital (At closing price)		12,000
Less: Capital to be maintained		
Opening capital (At closing price)	14,400	
Introduction (At closing price)	Nil	(14,400)
Retained profit/(loss)		(2,400)

Physical Capital Maintenance

	Rs.	Rs.
Closing capital (At current cost) (4,800 units)		12,000
Less: Capital to be maintained		
Opening capital (At current cost) (6,000 units)	15,000	
Introduction (At current cost)	Nil	(15,000)
Loss resulting in non-maintenance of capital		(3,000)

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TEST YOUR KNOWLEDGE

MCQs

1. **The 'going concern' concept assumes that**
   a. **The business can continue in operational existence for the foreseeable future.**
   b. **The business cannot continue in operational existence for the foreseeable future.**
   c. **The business is continuing to be profitable.**
   d. **The business cannot continue if it is not able to earn profits.**

2. **Two principal qualitative characteristics of financial statements are**
   a. **Understandability and materiality**
   b. **Relevance and reliability**
   c. **Relevance and materiality**
   d. **Comparability and materiality.**

3. **All of the following are components of financial statements except**
   a. **Balance sheet**
   b. **Statement of Profit and loss**
   c. **Human responsibility report**
   d. **Social responsibility report.**

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4. **An accounting policy can be changed if the change is required**
   a. **By statute or accounting standard**
   b. **For more appropriate presentation of financial statements**
   c. **Both (a) and (b)**
   d. **By statute as well as accounting standards.**

5. **Value of equity may change due to**
   a. **Contribution from or Distribution to equity participants**
   b. **Income earned**
   c. **expenses incurred**
   d. **All the three.**

ANSWERS/HINTS

MCQs

1.	**a.**	The business can continue in operational existence for the foreseeable future.
2.	**b.**	Relevance and reliability
3.	**c.**	Human responsibility report
4.	**c.**	Both (a) and (b)
5.	**d.**	All the three.

THEORETICAL QUESTIONS

Q.NO.1. What are the qualitative characteristics of the financial statements which improve the usefulness of the information furnished therein?

ANSWER

The qualitative characteristics are attributes that improve the usefulness of information provided in financial statements. Understandability; Relevance; Reliability; Comparability are the qualitative characteristics of financial statements. For details, refer para 7 of the chapter.

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Q.NO.2. "One of the characteristics of financial statements is neutrality"- Do you agree with this statement?

ANSWER

Yes, one of the characteristics of financial statements is neutrality. To be reliable, the information contained in financial statement must be neutral, that is free from bias. Financial Statements are not neutral if by the selection or presentation of information, the focus of analysis could shift from one area of business to another thereby arriving at a totally different conclusion on the business results.

PRACTICAL QUESTIONS

Q.NO.1. Mohan started a business on 1st April 20X1 with Rs. 12,00,000 represented by 60,000 units of Rs. 20 each. During the financial year ending on 31st March, 20X2, he sold the entire stock for Rs. 30 each. In order to maintain the capital intact, calculate the maximum amount, which can be withdrawn by Mohan in the year 20X1-X2 if Financial Capital is maintained at historical cost.

SOLUTION

Particulars	Financial Capital Maintenance at Historical Cost (Rs.)
Closing equity (Rs. 30 x 60,000 units)	 18,00,000 represented by cash
Opening equity	60,000 units x Rs. 20 = 12,00,000
Permissible drawings to keep Capital intact	6,00,000 (18,00,000 – 12,00,000)

Q.NO.2. Opening Balance Sheet of Mr. A is showing the aggregate value of assets, liabilities and equity Rs. 8 lakh, Rs. 3 lakh and Rs. 5 lakh respectively. During accounting period, Mr. A has the following transactions:

1. **Earned 10% dividend on 2,000 equity shares held of Rs. 100 each**
2. **Paid Rs. 50,000 to creditors for settlement of Rs. 70,000**
3. **Rent of the premises is outstanding Rs. 10,000**
4. **Mr. A withdrew Rs. 9,000 for his personal use.**

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SOLUTION

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

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

Q.NO.3. Balance Sheet of Anurag Trading Co. on 31st March, 20X1 is given below:

Liabilities	Rs.	Assets	Rs.
Capital	**50,000**	**Property, Plant and Equipment**	**69,000**
Profit and Loss Account	**22,000**	**Stock in Trade**	**36,000**
10% Loan	**43,000**	**Trade receivables**	**10,000**
Trade payables	**18,000**	**Deferred expenditure**	**15,000**
		Bank	**3,000**
	1,33,000		**1,33,000**

Additional Information:

i. **Remaining life of Property, Plant and Equipment is 5 years with even use. The net realisable value of Property, Plant and Equipment as on 31st March, 20X2 was Rs. 64,000.**

ii. **Firm's sales and purchases for the year 20X1-X2 amounted to Rs. 5 lakh and Rs. 4.50 lakh respectively.**

iii. **The cost and net realisable value of the stock were Rs. 34,000 and Rs. 38,000 respectively.**

iv. **General Expenses for the year 20X1-X2 were Rs. 16,500.**

v. **Deferred Expenditure is normally amortised equally over 4 years starting from F.Y. 20X0-X1 i.e. Rs. 5,000 per year.**

vi. **Out of trade receivables worth Rs.10,000, collection of Rs.4,000 depends on successful re-design of certain product already supplied to the customer.**

vii. **Closing trade payable is Rs.10,000, which is likely to be settled at 95%.**

viii. **There is pre-payment penalty of Rs.2,000 for Bank loan outstanding.**

Prepare Profit & loss Account for the year ended 31st March, 20X2 by assuming it is not a Going Concern.

<u>SOLUTION</u>

Profit and Loss Account of Anurag Trading Co. for the year ended 31st March, 20X2 (Assuming business is not a going concern)

	Rs.		Rs.
To Opening Stock	36,000	By Sales	5,00,000
To Purchases	4,50,000	By Trade payables	500
To Expenses	16,500	By Closing Stock	38,000
To Depreciation (69,000-64,000)	5,000		
To Provision for doubtful debts	4,000		

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To Deferred expenditure To Loan penalty To Net Profit (b.f.)	15,000 2,000 10,000		
	5,38,500		5,38,500

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3. APPLICABILITY OF ACCOUNTING STANDARDS

LEARNING OUTCOMES

After studying this chapter, you will be able to:

- Comprehend the status of Accounting Standards;
- Understand the applicability of Accounting Standards.

1. STATUS OF ACCOUNTING STANDARDS

It has already been mentioned in chapter 1 that the standards are developed by the Accounting Standards Board (ASB) of the Institute of Chartered Accountants of India and are issued under the authority of its Council which are approved by the MCA (Ministry of Corporate Affairs) for corporate entities. The standards cannot override laws and local regulations. The Accounting Standards are nevertheless made mandatory from the dates notified by the MCA and are generally applicable to all enterprises, subject to certain exceptions as stated below. The implication of mandatory status of an Accounting Standard depends on whether the statute governing the enterprise concerned requires compliance with the Standard, e.g., the Ministry of Corporate Affairs have notified Accounting Standards for companies incorporated under the Companies Act, 1956 (or the Companies Act, 2013).

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In assessing whether an accounting standard is applicable, one must find correct answer to the following three questions.

a. Does it apply to the enterprise concerned? If yes, the next question is:

b. Does it apply to the financial statement concerned? If yes, the next question is:

c. Does it apply to the financial item concerned?

The preface to the statements of accounting standards answers the above questions.

Enterprises to which the accounting standards apply?

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

Implication of mandatory status

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

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

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

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

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

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

Note: As per the Companies Act, 2013, the Central Government may prescribe standards of accounting or addendum thereto, as recommended by the Institute of Chartered Accountants of India, in consultation with the National Financial Reporting Authority (NFRA).

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Financial items to which the accounting standards apply

The Accounting Standards are intended to apply only to items, which are material. An item is considered material, if its omission or misstatement is likely to affect economic decision of the user. Materiality is not necessarily a function of size; it is the information content i.e. the financial item which is important. A penalty of Rs.50,000 paid for breach of law by a company can seem to be a relatively small amount for a company incurring crore of rupees in a year, yet is a material item because of the information it conveys. The materiality should, therefore, be judged on a case-to-case basis. If an item is material, it should be shown separately instead of clubbing it with other items. For example, it is not appropriate to club the penalties paid with legal charges.

Accounting Standards and Income Tax Act, 1961

Accounting standards intend to reduce diversity in application of accounting principles. They improve comparability of financial statements and promote transparency and fairness in their presentation. Deductions and exemptions allowed in computation of taxable income on the other hand, is a matter of fiscal policy of the government.

Thus, an expense required to be taken to the Statement of profit and loss by an accounting standard does not imply that the same is always deductible for income tax purposes. For example, depreciation on assets taken on finance lease is charged in the books of lessee as per AS 19 but depreciation for tax purposes is allowed to lessor, being legal owner of the asset, rather than to lessee. Likewise, recognition of revenue in the financial statements cannot be avoided simply because it is exempted under Section 10 of the Income Tax Act, 1961.

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Income Computation and Disclosure Standards

Section 145(2) of the Income Tax Act, 1961, empowers the Central Government to notify in the Official Gazette from time to time, Income Computation and Disclosure Standards to be followed by any class of assesses or in respect of any class of income. Accordingly, the Central Government has, in exercise of the powers conferred under Section 145(2) of the Income Tax Act, 1961, notified ten Income Computation and Disclosure Standards (ICDSs) to be followed by all assesses (other than an individual or a Hindu undivided family who is not required to get his accounts of the previous year audited in accordance with the provisions of Section 44AB of the Income Tax Act, 1961) following the mercantile system of accounting, for the purposes of computation of income chargeable to income-tax under the head “Profit and gains of business or profession” or “ Income from other sources”, from the Assessment Year (A.Y.) 2017-18. The ten notified ICDSs are:

ICDS I : Accounting Policies

ICDS II	:	Valuation of Inventories
ICDS III	:	Construction Contracts
ICDS IV	:	Revenue Recognition
ICDS V	:	Tangible Fixed Assets
ICDS VI	:	The Effects of Changes in Foreign Exchange Rates
ICDS VII	:	Government Grants
ICDS VIII	:	Securities
ICDS IX	:	Borrowing Costs
ICDS X	:	Provisions, Contingent Liabilities and Contingent Assets

2. APPLICABILITY OF ACCOUNTING STANDARDS

For the purpose of compliance of the accounting Standards, the ICAI has issued an announcement on 'Criteria for Classification of Entities and Applicability of Accounting Standards'. As per the announcement, entities are classified into four levels. Level IV, Level III and Level II entities as per the said Announcement were referred to as Micro, Small and Medium Entities (MSMEs).

However, when the accounting standards were notified by the Central Government in consultation with the National Advisory Committee on Accounting Standards∗, the Central Government also issued the 'Criteria for Classification of Entities and Applicability of Accounting Standards' for the companies.

According to the 'Criteria for Classification of Entities and Applicability of Accounting Standards' as issued by the Government, there are two levels, namely, Small and Medium-sized Companies (SMCs) as defined in the Companies (Accounting Standards) Rules, 2021 and companies other than SMCs (Non-SMCs). Non-SMCs are required to comply with all the Accounting Standards in their entirety, while certain exemptions/ relaxations have been given to SMCs.

"Criteria for Classification of Entities and Applicability of Accounting Standards" for corporate entities and non-corporate entities have been explained in the coming paragraphs.

2.1. Criteria for classification of Non-company entities for applicability of Accounting Standards

The Council of the ICAI, at its 400th meeting, held on March 18-19, 2021, considered the matter relating to applicability of Accounting Standards issued by the ICAI, to Non-company entities (Enterprises). The scheme for applicability of Accounting Standards to Non-company entities shall come into effect in respect of accounting periods commencing on or after 1 April 2020.

1. For the purpose of applicability of Accounting Standards, Non-company entities are classified into four categories, viz., Level I, Level II, Level III and Level IV.

Level I entities are large size entities, Level II entities are medium size entities, Level III entities are small size entities and Level IV entities are micro entities. Level IV, Level III and Level II

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entities are referred to as Micro, Small and Medium size entities (MSMEs). The criteria for classification of Non-company entities into different levels are given in Annexure 1.

The terms 'Small and Medium Enterprise' and 'SME' used in Accounting Standards shall be read as 'Micro, Small and Medium size entity' and 'MSME' respectively.

2. Level I entities are required to comply in full with all the Accounting Standards.

3. Certain exemptions/relaxations have been provided to Level II, Level III and Level IV Non-company entities. Applicability of Accounting Standards and exemptions/relaxations to such entities are given in Annexure 2.

4. This Announcement supersedes the earlier Announcement of the ICAI on **'Harmonisation of various differences between the Accounting Standards issued by the ICAI and the Accounting Standards notified by the Central Government'** issued in February 2008, to the extent it prescribes the criteria for classification of Non-company entities (Non-corporate entities) and applicability of Accounting Standards to non-company entities, and the Announcement **'Revision in the criteria for classifying Level II non-corporate entities'** issued in January 2013.

5. This Announcement is not relevant for Non-company entities who may be required to follow Ind AS as per relevant regulatory requirements applicable to such entities. Recurrence

Annexure 1

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

Level I Entities

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

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

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

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

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

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

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Level II Entities

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

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

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

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

Level III Entities

Non-company entities which are not covered under Level I and Level II but fall in any one or more of the following categories are classified as Level III entities:

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

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

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

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Level IV Entities

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

Additional requirements

1. An MSME which avails the exemptions or relaxations given to it shall disclose (by way of a note to its financial statements) the fact that it is an MSME, the Level of MSME and that it has complied with the Accounting Standards insofar as they are applicable to entities falling in Level II or Level III or Level IV, as the case may be.

2. Where an entity, being covered in Level II or Level III or Level IV, had qualified for any exemption or relaxation previously but no longer qualifies for the relevant exemption or relaxation in the current accounting period, the relevant standards or requirements become applicable from the current period and the figures for the corresponding period of the previous accounting period need not be revised merely by reason of its having ceased to be covered in Level II or Level III or

Level IV, as the case may be. The fact that the entity was covered in Level II or Level III or Level IV, as the case may be, in the previous period and it had availed of the exemptions or relaxations available to that Level of entities shall be disclosed in the notes to the financial statements. The fact that previous period figures have not been revised shall also be disclosed in the notes to the financial statements.

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

4. If an entity covered in Level II or Level III or Level IV opts not to avail of the exemptions or relaxations available to that Level of entities in respect of any but not all of the Accounting Standards, it shall disclose the Standard(s) in respect of which it has availed the exemption or relaxation.

5. If an entity covered in Level II or Level III or Level IV opts not to avail any one or more of the exemptions or relaxations available to that Level of entities, it shall comply with the relevant requirements of the Accounting Standard.

6. An entity covered in Level II or Level III or Level IV may opt for availing certain exemptions or relaxations from compliance with the requirements prescribed in an Accounting Standard: Provided that such a partial exemption or relaxation and disclosure shall not be permitted to mislead any person or public.

7. In respect of Accounting Standard (AS) 15, Employee Benefits, exemptions/ relaxations are available to Level II and Level III entities, under two sub classifications, viz., (i) entities whose average number of persons employed during the year is 50 or more, and (ii) entities whose average number of persons employed during the year is less than 50. The requirements stated in paragraphs (1) to (6) above, mutatis mutandis, apply to these sub-classifications.

Annexure 2

Applicability of Accounting Standards to Non-company Entities

The Accounting Standards issued by the ICAI, as on April 1, 2020, and such standards as issued from time-to-time are applicable to Non-company entities subject to the relaxations and exemptions in the announcement. The Accounting Standards issued by ICAI as on April 1, 2020, are:

AS 1 Disclosure of Accounting Policies
AS 2 Valuation of Inventories

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AS 3 Cash Flow Statements
AS 4 Contingencies and Events Occurring After the Balance Sheet Date
AS 5 Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies
AS 7 Construction Contracts
AS 9 Revenue Recognition
AS 10 Property, Plant and Equipment
AS 11 The Effects of Changes in Foreign Exchange Rates
AS 12 Accounting for Government Grants
AS 13 Accounting for Investments
AS 14 Accounting for Amalgamations
AS 15 Employee Benefits
AS 16 Borrowing Costs
AS 17 Segment Reporting
AS 18 Related Party Disclosures
AS 19 Leases
AS 20 Earnings Per Share
AS 21 Consolidated Financial Statements
AS 22 Accounting for Taxes on Income
AS 23 Accounting for Investments in Associates in Consolidated Financial Statements
AS 24 Discontinuing Operations
AS 25 Interim Financial Reporting
AS 26 Intangible Assets
AS 27 Financial Reporting of Interests in Joint Ventures
AS 28 Impairment of Assets
AS 29 Provisions, Contingent Liabilities and Contingent Assets

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1. **Applicability of the Accounting Standards to Level 1 Non- company entities.**

   Level I entities are required to comply in full with all the Accounting Standards.

2. **Applicability of the Accounting Standards and exemptions/relaxations for Level II, Level III and Level IV Non-company entities**

A. Accounting Standards applicable to Non-company entities

AS	Level II Entities	Level III Entities	Level IV Entities
AS 1	Applicable	Applicable	Applicable

AS 2	Applicable	Applicable	Applicable
AS 3	Not Applicable	Not Applicable	Not Applicable
AS 4	Applicable	Applicable	Applicable
AS 5	Applicable	Applicable	Applicable
AS 7	Applicable	Applicable	Applicable
AS 9	Applicable	Applicable	Applicable
AS 10	Applicable	Applicable with disclosures exemption	Applicable with disclosures exemption
AS 11	Applicable	Applicable with disclosures exemption	Applicable with disclosures exemption
AS 12	Applicable	Applicable	Applicable
AS 13	Applicable	Applicable	Applicable with disclosures exemption
AS 14	Applicable	Applicable	Not Applicable (Refer note 2(C))
AS 15	Applicable with exemptions	Applicable with exemptions	Applicable with exemptions
AS 16	Applicable	Applicable	Applicable
AS 17	Not Applicable	Not Applicable	Not Applicable
AS 18	Applicable	Not Applicable	Not Applicable
AS 19	Applicable with disclosures exemption	Applicable with disclosures exemption	Applicable with disclosures exemption
AS 20	Not Applicable	Not Applicable	Not Applicable
AS 21	Not Applicable (Refer note 2(D))	Not Applicable (Refer note 2(D))	Not Applicable (Refer note 2(D))
AS 22	Applicable	Applicable	Applicable only for current tax related provisions (Refer note 2(B)(vi))
AS 23	Not Applicable (Refer note 2(D))	Not Applicable (Refer note 2(D))	Not Applicable (Refer note 2(D))
AS 24	Applicable	Not Applicable	Not Applicable
AS 25	Not Applicable (Refer note 2(D))	Not Applicable (Refer note 2(D))	Not Applicable (Refer note 2(D))

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AS 26	Applicable	Applicable	Applicable with disclosures exemption
AS 27	Not Applicable (Refer notes 2(C) and 2(D))	Not Applicable (Refer notes 2(C) and 2(D))	Not Applicable (Refer notes 2(C) and 2(D))
AS 28	Applicable with disclosures exemption	Applicable with disclosures exemption	Not Applicable
AS 29	Applicable with disclosures exemption	Applicable with disclosures exemption	Applicable with disclosures exemption

B. Accounting Standards in respect of which relaxations/exemptions from certain requirements have been given to Level II, Level III and Level IV Non-company entities:

i. Accounting Standard (AS) 10, Property, Plant and Equipments

Paragraph 87 relating to encouraged disclosures is not applicable to Level III and Level IV Non-company entities.

ii. AS 11, The Effects of Changes in Foreign Exchange Rates (revised 2018)

Paragraph 44 relating to encouraged disclosures is not applicable to Level III and Level IV Non-company entities.

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iii. AS 13, Accounting for Investments

Paragraph 35(f) relating to disclosures is not applicable to Level IV Non-company entities.

iv. Accounting Standard (AS) 15, Employee Benefits (revised 2005)

1. Level II and Level III Non-company entities whose average number of persons employed during the year is 50 or more are exempted from the applicability of the following paragraphs:

a. paragraphs 11 to 16 of the standard to the extent they deal with recognition and measurement of short-term accumulating compensated absences which are non-vesting (i.e., short-term accumulating compensated absences in respect of which employees are not entitled to cash payment for unused entitlement on leaving);

b. paragraphs 46 and 139 of the Standard which deal with discounting of amounts that fall due more than 12 months after the balance sheet date;

c. recognition and measurement principles laid down in paragraphs 50 to 116 and presentation and disclosure requirements laid down in paragraphs 117 to 123 of the Standard in respect of accounting for defined benefit plans. However, such entities

should actuarially determine and provide for the accrued liability in respect of defined benefit plans by using the Projected Unit Credit Method and the discount rate used should be determined by reference to market yields at the balance sheet date on government bonds as per paragraph 78 of the Standard. Such entities should disclose actuarial assumptions as per paragraph 120(l) of the Standard; and

d. recognition and measurement principles laid down in paragraphs 129 to 131 of the Standard in respect of accounting for other long-term employee benefits. However, such entities should actuarially determine and provide for the accrued liability in respect of other long-term employee benefits by using the Projected Unit Credit Method and the discount rate used should be determined by reference to market yields at the balance sheet date on government bonds as per paragraph 78 of the Standard.

2. Level II and Level III Non-company entities whose average number of persons employed during the year is less than 50 and Level IV Non-company entities irrespective of number of employees are exempted from the applicability of the following paragraphs:

a. paragraphs 11 to 16 of the standard to the extent they deal with recognition and measurement of short-term accumulating compensated absences which are non-vesting (i.e., short-term accumulating compensated absences in respect of which employees are not entitled to cash payment for unused entitlement on leaving);

b. paragraphs 46 and 139 of the Standard which deal with discounting of amounts that fall due more than 12 months after the balance sheet date;

c. recognition and measurement principles laid down in paragraphs 50 to 116 and presentation and disclosure requirements laid down in paragraphs 117 to 123 of the Standard in respect of accounting for defined benefit plans. However, such entities may calculate and account for the accrued liability under the defined benefit plans by reference to some other rational method, e.g., a method based on the assumption that such benefits are payable to all employees at the end of the accounting year; and

d. recognition and measurement principles laid down in paragraphs 129 to 131 of the Standard in respect of accounting for other long-term employee benefits. Such entities may calculate and account for the accrued liability under the other long-term employee benefits by reference to some other rational method, e.g., a method based on the assumption that such benefits are payable to all employees at the end of the accounting year.

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v. AS 19, Leases

a. Paragraphs 22 (c),(e) and (f); 25 (a), (b) and (e); 37 (a) and (f); and 46 (b) and (d) relating to disclosures are not applicable to Level II Non-company entities.

b. Paragraphs 22 (c),(e) and (f); 25 (a), (b) and (e); 37 (a), (f) and (g); and 46 (b), (d) and (e) relating to disclosures are not applicable to Level III Non-company entities.

c. Paragraphs 22 (c),(e) and (f); 25 (a), (b) and (e); 37 (a), (f) and (g); 38; and 46 (b), (d) and (e) relating to disclosures are not applicable to Level IV Non-company entities.

vi. AS 22, Accounting for Taxes on Income

a. Level IV Non-company entities shall apply the requirements of AS 22, Accounting for Taxes on Income, for Current tax defined in paragraph 4.4 of AS 22, with recognition as per paragraph 9, measurement as per paragraph 20 of AS 22, and presentation and disclosure as per paragraphs 27-28 of AS 22.

b. Transitional requirements

On the first occasion when a Non-company entity gets classified as Level IV entity, the accumulated deferred tax asset/liability appearing in the financial statements of immediate previous accounting period, shall be adjusted against the opening revenue reserves.

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vii. AS 26, Intangible Assets

Paragraphs 90(d)(iii); 90(d)(iv) and 98 relating to disclosures are not applicable to Level I Non-company entities.

viii. AS 28, Impairment of Assets

a. Level II and Level III Non-company entities are allowed to measure the 'value in use' on the basis of reasonable estimate thereof instead of computing the value in use by present value technique. Consequently, if Level II or Level III Non-company entity chooses to measure the 'value in use' by not using the present value technique, the relevant provisions of AS 28, such as discount rate etc., would not be applicable to such an entity. Further, such an entity need not disclose the information required by paragraph 121(g) of the Standard.

b. Also, paragraphs 121(c) (ii); 121(d) (i); 121(d) (ii) and 123 relating to disclosures are not applicable to Level III Non-company entities.

ix. AS 29, Provisions, Contingent Liabilities and Contingent Assets (revised 2016)

Paragraphs 66 and 67 relating to disclosures are not applicable to Level II, Level III and Level IV Non-company entities.

C. In case of Level IV Non-company entities, generally there are no such transactions that are covered under AS 14, Accounting for Amalgamations, or jointly controlled operations or jointly controlled assets covered under AS 27, Financial Reporting of Interests in Joint Ventures. Therefore, these standards are not applicable to Level IV Non-company entities. However, if there are any such transactions, these entities shall apply the requirements of the relevant standard.

D. AS 21, Consolidated Financial Statements, AS 23, Accounting for Investments in Associates in Consolidated Financial Statements, AS 27, Financial Reporting of Interests in Joint Ventures (to the extent of requirements relating to Consolidated Financial Statements), and AS 25, Interim Financial Reporting, do not require a Non-company entity to present consolidated financial statements and interim financial report, respectively. Relevant AS is applicable only if a Non-company entity is required or elects to prepare and present consolidated financial statements or interim financial report.

Example 1

M/s Omega & Co. (a partnership firm), had a turnover of Rs.1.25 crore (excluding other income) and borrowings of Rs.0.95 crore in the previous year. It wants to avail the exemptions available in application of Accounting Standards to non-corporate entities for the year ended 31.3.20X1. Advise the management of M/s Omega & Co in respect of the exemptions of provisions of ASs, as per the directive issued by the ICAI.

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Solution

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

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

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

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

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

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

2.2 Criteria for classification of Companies under the Companies (Accounting Standards) Rules, 2021

Small and Medium-Sized Company (SMC) as defined in Clause 2(e) of the Companies (Accounting Standards) Rules, 2021:

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

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

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

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

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

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

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

Non-SMCs

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

Instructions

- General Instructions

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

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

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"The Company is a Small and Medium Sized Company (SMC) as defined in the Companies (Accounting Standards) Rules, 2021 notified under the Companies Act, 2013. Accordingly, the Company has complied with the Accounting Standards as applicable to a Small and Medium Sized Company."

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

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

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

1.5 The SMC may opt for availing certain exemptions or relaxations from compliance with the requirements prescribed in an Accounting Standard:

Provided that such a partial exemption or relaxation and disclosure should not be permitted to mislead any person or public.

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Note:

An existing company which was previously not a SMC and subsequently becomes a SMC, shall not be qualified for exemption or relaxation in respect of Accounting Standards available to a SMC until the company remains a SMC for two consecutive accounting periods.

2.3 Applicability of Accounting Standards to Companies other than those following Indian Accounting Standards (Ind AS)1

2.3.1 Accounting Standards applicable in their entirety to companies

AS 1	Disclosures of Accounting Policies
AS 2	Valuation of Inventories (revised 2016)
AS 3	Cash Flow Statements
AS 4	Contingencies and Events Occurring After the Balance Sheet Date (revised 2016)
AS 5	Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies

AS 7	Construction Contracts (revised 2002)
AS 9	Revenue Recognition
AS 10	Property, Plant and Equipment
AS 11	The Effects of Changes in Foreign Exchange Rates (revised 2003)
AS 12	Accounting for Government Grants
AS 13	Accounting for Investments (revised 2016)
AS 14	Accounting for Amalgamations (revised 2016)
AS 16	Borrowing Costs
AS 18	Related Party Disclosures
AS 21	Consolidated Financial Statements (revised 2016)
AS 22	Accounting for Taxes on Income
AS 23	Accounting for Investments in Associates in Consolidated Financial Statements
AS 24	Discontinuing Operations
AS 26	Intangible Assets
AS 27	Financial Reporting of Interest in Joint Ventures

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2.3.2 Exemptions or Relaxations for Small and Medium Sized Companies (SMCs) as defined in the Notification dated June 23, 2021, issued by the Ministry of Corporate Affairs, Government of India

1. Accounting Standards not applicable to SMCs in their entirety:

AS 17 Segment Reporting

2. Accounting Standards in respect of which relaxations from certain requirements have been given to SMCs:

i. Accounting Standard (AS) 15, Employee Benefits (revised 2005)

a. paragraphs 11 to 16 of the standard to the extent they deal with recognition and measurement of short-term accumulating compensated absences which are non-vesting (i.e., short-term accumulating compensated absences in respect of which employees are not entitled to cash payment for unused entitlement on leaving);

b. paragraphs 46 and 139 of the Standard which deal with discounting of amounts that fall due more than 12 months after the balance sheet date;

c. recognition and measurement principles laid down in paragraphs 50 to 116 and presentation and disclosure requirements laid down in paragraphs 117 to 123 of the Standard in respect of accounting for defined benefit plans. However, such companies should actuarially determine and provide for the accrued liability in respect of defined benefit plans by using the Projected Unit Credit Method and the discount rate used

should be determined by reference to market yields at the balance sheet date on government bonds as per paragraph 78 of the Standard. Such companies should disclose actuarial assumptions as per paragraph 120(l) of the Standard; and

d. recognition and measurement principles laid down in paragraphs 129 to 131 of the Standard in respect of accounting for other long-term employee benefits. However, such companies should actuarially determine and provide for the accrued liability in respect of other long-term employee benefits by using the Projected Unit Credit Method and the discount rate used should be determined by reference to market yields at the balance sheet date on government bonds as per paragraph 78 of the Standard.

ii. <u>AS 19, Leases</u>

Paragraphs 22 (c), (e) and (f); 25 (a), (b) and (e); 37 (a) and (f); and 46 (b) and (d) relating to disclosures are not applicable to SMCs.

iii. <u>AS 20, Earnings Per Share</u>

Disclosure of diluted earnings per share (both including and excluding extraordinary items) is exempted for SMCs.

iv. <u>AS 28, Impairment of Assets</u>

SMCs are allowed to measure the 'value in use' on the basis of reasonable estimate thereof instead of computing the value in use by present value technique. Consequently, if an SMC chooses to measure the 'value in use' by not using the present value technique, the relevant provisions of AS 28, such as discount rate etc., would not be applicable to such an SMC. Further, such an SMC need not disclose the information required by paragraph 121(g) of the Standard.

v. <u>AS 29, Provisions, Contingent Liabilities and Contingent Assets (revised)</u>

Paragraphs 66 and 67 relating to disclosures are not applicable to SMCs.

3. AS 25, Interim Financial Reporting, does not require a company to present interim financial report. It is applicable only if a company is required or elects to prepare and present an interim financial report. Only certain Non-SMCs are required by the concerned regulators to present interim financial results, e.g., quarterly financial results required by the SEBI. Therefore, the recognition and measurement requirements contained in this Standard are applicable to those Non-SMCs for preparation of interim financial results.

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SUMMARY

According to the Criteria for Classification of Entities and Applicability of Accounting Standards as issued by the Government, there are two levels, namely, Small and Medium-sized Companies (SMCs) as defined in the Companies (Accounting Standards) Rules and companies other than SMCs. Non-SMCs are required to comply with all the Accounting Standards in their entirety, while certain exemptions/ relaxations have been given to SMCs. Criteria for classification of entities for applicability of accounting standards for corporate and non-corporate entities have been prescribed as per the Govt. notification.

SHRESHTA

TEST YOUR KNOWLEDGE

MCQs

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

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

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

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

5. "Small and Medium Sized Company" (SMC) means, a company-
   a. which may be a bank, financial institution or an insurance company.
   b. whose turnover (excluding other income) does not exceed rupees two-fifty crores in the immediately preceding accounting year;
   c. whose turnover (excluding other income) does not exceed rupees fifty crores in the immediately preceding accounting year;
   d. whose turnover (excluding other income) does not exceed rupees five hundred crore in the immediately preceding accounting year.

ANSWERS/HINTS

MCQs

1.	**c.**	fifty crores.
2.	**b.**	AS 17.
3.	**b.**	Level I entities.
4.	**c.**	Level III entities.
5.	**b.**	whose turnover (excluding other income) does not exceed rupees two-fifty crore in the immediately preceding accounting year;

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THEORY QUESTIONS

Q.NO.1. What are the issues, with which Accounting Standards deal?

ANSWER

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

Q.NO.2. List the criteria to be applied for rating a non-corporate entity as Level-I entity and Level II entity for the purpose of compliance of Accounting Standards in India.

ANSWER

Refer para 1.2.1 for Criteria to be applied for rating a non-corporate entity as Level-I entity and Level II entity for the purpose of compliance of Accounting Standards in India.

Q.NO.3. List the criteria to be applied for rating a non-corporate entity as Level IV entity for the purpose of compliance of Accounting Standards in India.

ANSWER

Refer para 1.2.1 for Criteria to be applied for rating a non-corporate entity as Level IV entity for the purpose of compliance of Accounting Standards in India.

PRACTICAL QUESTIONS

Q.NO.1. XYZ Ltd., with a turnover of Rs.50 crore during previous year and borrowings of Rs.1 crore during any time in the previous year, wants to avail the exemptions available in adoption of Accounting Standards applicable to companies for the year ended 31.3.20X1. Advise the management on the exemptions that are available as per the Companies (Accounting Standards) Rules, 2021.

ANSWER

The question deals with the issue of Applicability of Accounting Standards for corporate entities.

The companies can be classified under two categories viz SMCs and Non SMCs under the Companies (Accounting Standards) Rules, 2021.

As per the Companies (Accounting Standards) Rules, 2021, criteria for above classification as SMCs, are:

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

- whose equity or debt securities are not listed or are not in the process of listing on any stock exchange, whether in India or outside India;
- which is not a bank, financial institution or an insurance company;
- whose turnover (excluding other income) does not exceed rupees two fifty crore in the immediately preceding accounting year;
- which does not have borrowings (including public deposits) in excess of rupees fifty crore at any time during the immediately preceding accounting year; and
- which is not a holding or subsidiary company of a company which is not a small and medium-sized company.

  Since, XYZ Ltd.'s turnover was Rs.50 crore which does not exceed Rs.250 crore and borrowings of Rs.1 crore are less than Rs.50 crore, it is a small and medium sized company (SMC).

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Q.NO.2. A company was classified as Non-SMC in 20X1-X2. In 20X2-X3, it has been classified as SMC. The management desires to avail the exemptions or relaxations available for SMCs in 20X2-X3. However, the accountant of the company does not agree with the same. Comment.

ANSWER

As per Companies (Accounting Standards) Rules, 2021, an existing company, which was previously not a SMC and subsequently becomes a SMC, should not be qualified for exemption or relaxation in respect of accounting standards available to a SMC until the company remains a SMC for two consecutive accounting periods. Therefore, the management of the company cannot avail the exemptions/ relaxations available to the SMCs for the FY 20X2-X3.

4. PRESENTATION & DISCLOSURES BASED ACCOUNTING STANDARDS

UNIT 1: ACCOUNTING STANDARD 1 DISCLOSURE OF ACCOUNTING POLICIES

LEARNING OUTCOMES

After studying this chapter, you would be able to Comprehend the-

- Fundamental Accounting Assumptions
- Nature of Accounting Policies
- Areas in Which Different Accounting Policies are encountered.
- Considerations in the Selection of Accounting Policies.

1.1 INTRODUCTION

Irrespective of extent of standardization, diversity in accounting policies is unavoidable for two reasons. First, accounting standards cannot and do not cover all possible areas of accounting and enterprises have the freedom of adopting any reasonable accounting policy in areas not covered by a standard.

Second, since enterprises operate in diverse situations, it is impossible to develop a single set of policies applicable to all enterprises for all time.

The accounting standards, therefore, permit more than one policy even in areas covered by it. Differences in accounting policies lead to differences in reported information even if underlying transactions are same. The qualitative characteristic of comparability of financial statements, therefore, suffers due to diversity of accounting policies. Since uniformity is impossible, and accounting standards permit more than one alternative in many cases, it is not enough to say that all standards have been complied with. For these reasons, Accounting Standard 1 requires enterprises to disclose significant accounting policies actually adopted by them in preparation of their financial statements. Such disclosures allow the users of financial statements to take the differences in accounting policies into consideration and to make necessary adjustments in their analysis of such financial statements.

The purpose of Accounting Standard 1, Disclosure of Accounting Policies, is to promote better understanding of financial statements by requiring disclosure of significant accounting policies in an orderly manner. As explained in the preceding paragraph, such disclosures facilitate more meaningful comparison between financial statements of different enterprises for same accounting period.

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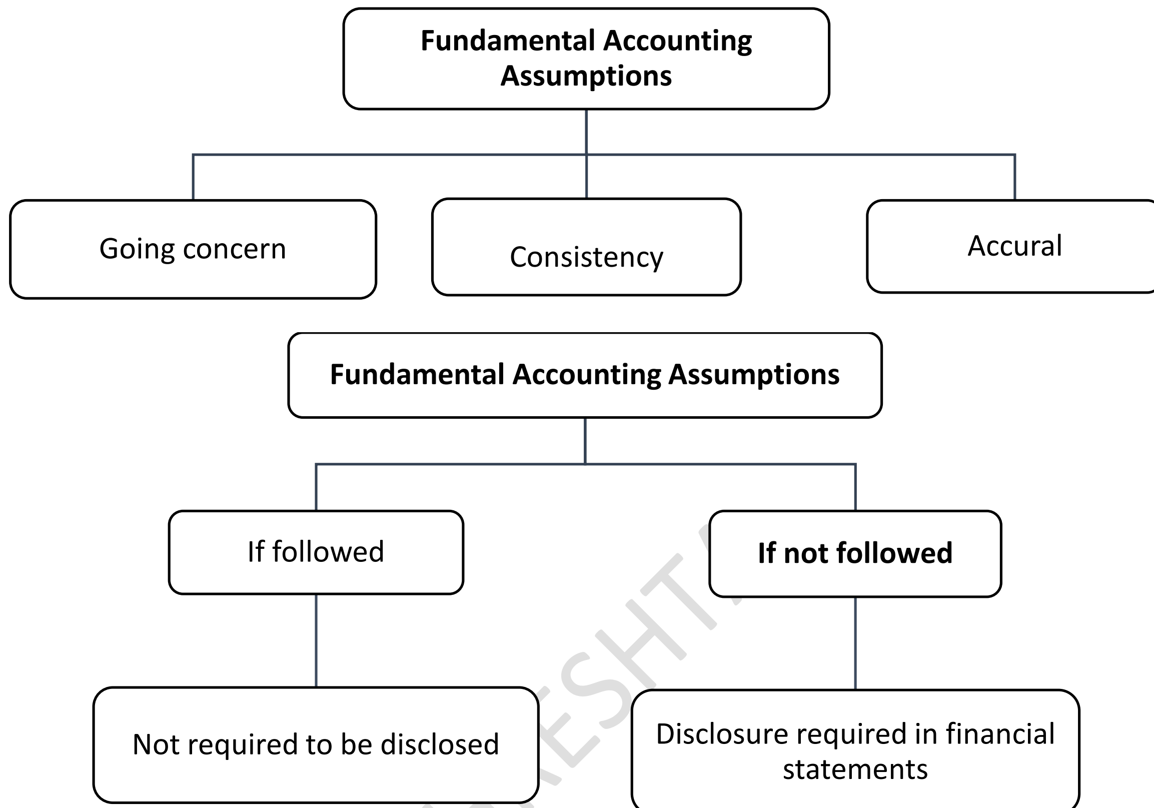
The standard also requires disclosure of changes in accounting policies such that the users can compare financial statements of same enterprise for different accounting periods.

This Accounting Standard applies to all enterprises.

1.2 FUNDAMENTAL ACCOUNTING ASSUMPTIONS



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Going Concern: The financial statements are normally prepared on the assumption that an enterprise will continue its operations in the foreseeable future and neither there is intention, nor there is need to materially curtail the scale of operations. Financial statements prepared on going concern basis recognise among other things the need for sufficient retention of profit to replace assets consumed in operation and for making adequate provision for settlement of its liabilities.

Consistency: The principle of consistency refers to the practice of using same accounting policies for similar transactions in all accounting periods. The consistency improves comparability of financial statements through time. An accounting policy can be changed if the change is required

i. by a statute

ii. by an accounting standard

iii. for more appropriate presentation of financial statements.

Accrual basis of accounting: Under this basis of accounting, transactions are recognised as soon as they occur, whether or not cash or cash equivalent is actually received or paid. Accrual basis ensures better matching between revenue and cost and profit/loss obtained on this basis reflects activities of the enterprise during an accounting period, rather than cash flows generated by it.

While accrual basis is a more logical approach to profit determination than the cash basis of accounting, it exposes an enterprise to the risk of recognising an income before actual receipt. The accrual basis can, therefore, overstate the divisible profits and dividend decisions based on such overstated profit lead to erosion of capital. For this reason, accounting standards require that no revenue should be recognised unless the amount of consideration and actual realisation of the consideration is reasonably certain.

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

1.3 ACCOUNTING POLICIES

The accounting policies refer to the specific accounting principles and the methods of applying those principles adopted by the enterprise in the preparation and presentation of financial statements. Accountant has to make decisions from various options for recording or disclosing items in the books of accounts e.g.

Items to be disclosed	Method of disclosure or valuation
Inventories	FIFO, Weighted Average etc.
Cash Flow Statement	Direct Method, Indirect Method

This list is not exhaustive i.e. endless. For every item right from valuation of assets and liabilities to recognition of revenue, providing for expected losses, for each event, accountant need to form principles and evolve a method to adopt those principles. This method of forming and applying accounting principles is known as accounting policies.

As we say that accounts is both science and art, it’s a science because we have some tested accounting principles, which are applicable universally, but simultaneously the application of these principles depends on the personal ability of each accountant. Since different accountants may have different approach, we generally find that in different enterprises under same industry, different accounting policies are followed. Though ICAI along with Government is trying to reduce the number of accounting policies followed in India but still it cannot be reduced to one. Accounting policy adopted will have considerable effect on the financial results disclosed by the financial statements; it makes it almost difficult to compare two financial statements.

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1.4 SELECTION OF ACCOUNTING POLICY

Financial Statements are prepared to portray a true and fair view of the performance and state of affairs of an enterprise. In selecting a policy, alternative accounting policies should be evaluated in that light. In particular, major considerations that govern selection of a particular policy are:

Prudence: In view of uncertainty associated with future events, profits are not anticipated, but losses are provided for as a matter of conservatism. Provision should be created for all known liabilities and losses even though the amount cannot be determined with certainty and represents only a best estimate in the light of available information. The exercise of prudence in selection of accounting policies ensure that (i) profits are not overstated (ii) losses are not understated (iii) assets are not overstated and (iv) liabilities are not understated.

Example 1

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

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

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

= Sale – Cost of goods sold = (400 x Rs. 15) – (500 x Rs. 10 – 100 x Rs. 10) = Rs. 2,000

Profit of the trader if net realisable value of unsold article is Rs. 8

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

Example 2

Exercise of prudence does not permit creation of hidden reserve by understating profits and assets or by overstating liabilities and losses. Suppose a company is facing a damage suit. No provision for damages should be recognised by a charge against profit, unless the probability of losing the suit is more than the probability of not losing it.

Substance over form: Transactions and other events should be accounted for and presented in accordance with their substance and financial reality and not merely by their legal form.

Materiality: Financial statements should disclose all 'material items, i.e. the items the knowledge of which might influence the decisions of the user of the financial statement. Materiality is not always a matter of relative size. For example a small amount lost by fraudulent practices of certain employees

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can indicate a serious flaw in the enterprise's internal control system requiring immediate attention to avoid greater losses in future. In certain cases quantitative limits of materiality is specified. A few of such cases are given below:

a. A company should disclose by way of notes additional information regarding any item of income or expenditure which exceeds 1% of the revenue from operations or Rs.1,00,000 whichever is higher (Refer general Instructions for preparation of Statement of Profit and Loss in Schedule III to the Companies Act, 2013).

b. A company should disclose in Notes to Accounts, shares in the company held by each shareholder holding more than 5 per cent shares specifying the number of shares held. (Refer general Instructions for Balance Sheet in Schedule III to the Companies Act, 2013).

Manner of disclosure: All significant accounting policies adopted in the preparation and presentation of financial statements should be disclosed

The disclosure of the significant accounting policies as such should form part of the financial statements and the significant accounting policies should normally be disclosed in one place.

1.5 DISCLOSURE OF CHANGES IN ACCOUNTING POLICIES

Any change in the accounting policies which has a material effect in the current period or which is reasonably expected to have a material effect in a later period should be disclosed. In the case of a change in accounting policies, which has a material effect in the current period, the amount by which any item in the financial statements is affected by such change should also be disclosed to the extent ascertainable. Where such amount is not ascertainable, wholly or in part, the fact should be indicated.

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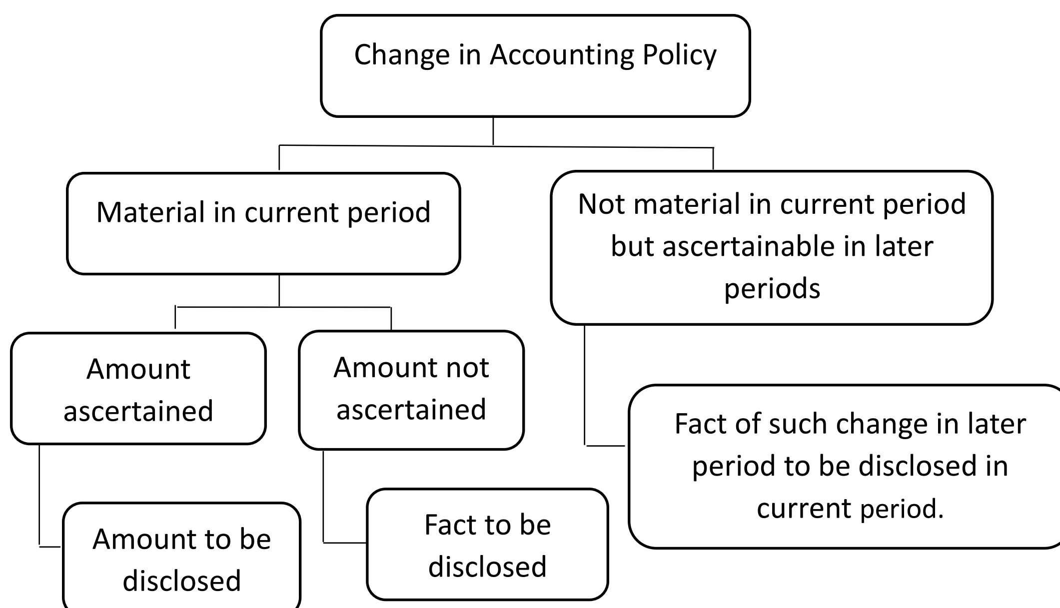

Example 3

A simple disclosure that an accounting policy has been changed is not of much use for a reader of a financial statement. The effect of change should, therefore, be disclosed wherever ascertainable. Suppose a company has switched over to weighted average formula for ascertaining cost of inventory, from the earlier practice of using FIFO. If the closing inventory using FIFO method is Rs.2 lakh and that by weighted average method is Rs.1.8 lakh, the change in accounting policy pulls down profit and value of inventory by Rs.20,000. The company may disclose the change in accounting policy in the following manner:

'The company values its inventory at lower of cost or net realisable value. Since net realisable value of all items of inventory in the current year was greater than respective costs, the company valued its inventory at cost. In the present year, the company has changed to weighted average method, which better reflects the consumption pattern of inventory, for ascertaining inventory costs from the earlier practice of using FIFO method for the purpose. The change in policy has reduced profit for the year and value of inventory as at the year-end by Rs.20,000.

A change in accounting policy is to be disclosed if the change is reasonably expected to have material effect in future accounting periods, even if the change has no material effect in the current accounting period.

The above requirement ensures that all important changes in accounting policies are actually disclosed.

1.6 DISCLOSURE OF DEVIATIONS FROM FUNDAMENTAL ACCOUNTING ASSUMPTIONS

If the fundamental accounting assumptions, viz. Going concern, Consistency and Accrual are followed in financial statements, specific disclosure is not required. If a fundamental accounting assumption is not followed, the fact should be disclosed.

The principle of consistency refers to the practice of using same accounting policies for similar transactions in all accounting periods.

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ILLUSTRATIONS

Illustration 1

In the books of M/s Prashant Ltd., closing inventory as at 31.03.20X2 amounts to Rs. 1,63,000 (on the basis of FIFO method).

The company decides to change from FIFO method to weighted average method for ascertaining the cost of inventory from the year 20X1-X2. On the basis of weighted average method, closing inventory as on 31.03.20X2 amounts to Rs. 1,47,000. Realisable value of the inventory as on 31.03.20X2 amounts to Rs. 1,95,000.

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

Solution

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

'The company values its inventory at lower of cost and net realizable value. Since net realizable value of all items of inventory in the current year was greater than respective costs, the company valued its inventory at cost. In the present year i.e. 20X1-X2, the company has changed to weighted average method, which better reflects the consumption pattern of inventory, for ascertaining inventory costs from the earlier practice of using FIFO for the purpose. The change in policy has reduced current profit and value of inventory by Rs. 16,000.

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Illustration 2

Jagannath Ltd. had made a rights issue of shares in 20X2. In the offer document to its members, it had projected a surplus of Rs.40 crore during the accounting year to end on 31st March, 20X2. The draft results for the year, prepared on the hitherto followed accounting policies and presented for perusal of the board of directors showed a deficit of Rs.10 crore. The board in consultation with the managing director, decided on the following:

i. **Value year-end inventory at works cost (Rs. 50 crore) instead of the hitherto method of valuation of inventory at prime cost (Rs. 30 crore).**
ii. **Provide for permanent diminution in the value of investments, which had taken place over the past five years, the amount of provision being Rs.10 crore.**

As chief accountant of the company, you are asked by the managing director to draft the notes on accounts for inclusion in the annual report for 20X1-20X2.

Solution

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

Notes on Accounts:

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

ii. The company has decided to provide Rs.10 crore for the permanent diminution in the value of investments which has taken place over the period of past five years. The provision so made has reduced the profit disclosed in the accounts by Rs.10 crore.

Illustration 3

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

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Solution

AS 1 'Disclosure of Accounting Policies' recognises 'prudence' as one of the major considerations governing the selection and application of accounting policies. In view of the uncertainty attached to future events, profits are not anticipated but recognised only when realised though not necessarily in cash. Provision is made for all known liabilities and losses even though the amount cannot be determined with certainty and represents only a best estimate in the light of available information. Also as per AS 1, 'accrual' is one of the fundamental accounting assumptions. Irrespective of the terms of the contract, so long as the principal amount of a loan is not repaid, the lender cannot be replaced in a disadvantageous position for non-payment of interest in respect of overdue amount. From the aforesaid, it is apparent that the company has an obligation on account of the overdue interest.

In this situation, the company should provide for the liability (since it is not waived by the lenders) at an amount estimated or on reasonable basis based on facts and circumstances of each case. However, in respect of the overdue interest amounts, which are settled, the liability should be accrued to the extent of amounts settled. Non-provision of the overdue interest liability amounts to violation of accrual basis of accounting. Therefore, the treatment, done by the company, of not providing the interest amount from due date to the date of repayment is not correct.

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Reference: The students are advised to refer the full text of AS 1 "Disclosure of Accounting Policies".

TEST YOUR KNOWLEDGE

MCQs

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

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

3. **Which of the following statement would not be correct in relation to disclosures to be made in the financial statements after making any change in an accounting policy?**
   a. **Any change in an accounting policy which has a material effect should be disclosed.**
   b. **The amount by which any item in the financial statements is affected by such change should be disclosed to the extent ascertainable. Where such amount is not ascertainable, wholly or in part, the fact should be indicated.**
   c. **If a change is made in the accounting policies which has no material effect on the financial statements for the current period but which is reasonably expected to have a material effect in later periods, the fact of such change should be appropriately disclosed in the period in which the change is adopted.**
   d. **If a change is made in an accounting policy which has material effect on the financial statements for the current period and is reasonably expected to have a material effect in later periods, the fact of such change should be appropriately disclosed only in the later periods i.e. year(s) next to the year in which the change is adopted.**

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ANSWERS/HINTS

MCQs

1.	**b.**	Comparability
2.	**a.**	Comparability
3.	**d.**	If a change is made in an accounting policy which has material effect on the financial statements for the current period and is reasonably expected to have a material effect in later periods, the fact of such change should be appropriately disclosed only in the later periods i.e. year(s) next to the year in which the change is adopted.

THEORETICAL QUESTIONS

Q.NO.1. What are the three fundamental accounting assumptions recognised by Accounting Standard (AS) 1? Briefly describe each one of them.

ANSWER

Accounting Standard (AS) 1 recognises three fundamental accounting assumptions. These are:
(i) Going Concern; (ii) Consistency; and (iii) Accrual basis of accounting.

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Q.NO.2. Has Accounting Standard 1 prescribed the manner in which the accounting policies followed by the entity should be disclosed?

ANSWER

Paras 18-20 of Accounting Standard 1, Disclosure of Accounting Policies, lay down the manner in which accounting policies have to be disclosed, which is stated as under:

- To ensure proper understanding of financial statements, it is necessary that all significant accounting policies adopted in the preparation and presentation of financial statements should be disclosed.
- Such disclosure should form part of the financial statements.
- All the disclosures should be made at one place instead of being scattered over several statements, schedules and notes.

PRACTICAL QUESTIONS

Q.NO.1. State whether the following statements are 'True' or 'False'. Also give reason for your answer.

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

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

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

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

SOLUTION

i. False: As per AS 1 "Disclosure of Accounting Policies", certain fundamental accounting assumptions underlie the preparation and presentation of financial statements. They are usually not specifically stated because their acceptance and use are assumed. Disclosure is necessary if they are not followed.

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

iii. True: To ensure proper understanding of financial statements, it is necessary that all significant accounting policies adopted in the preparation and presentation of financial statements should be disclosed. The disclosure of the significant accounting policies as such should form part of the financial statements and they should be disclosed in one place.

iv. False: Any change in the accounting policies which has a material effect in the current period or which is reasonably expected to have a material effect in later periods should be disclosed. Where such amount is not ascertainable, wholly or in part, the fact should be indicated.

Q.NO.2. Give examples of areas where accounting policies adopted could be different for different enterprises. Would there be any adverse impact due to the adoption of different policies, and if yes, how does Accounting Standard 1 seek to address such issue?

SOLUTION

There are various areas where different accounting policies could be adopted by different entities within the same industry. An entity may choose to value its inventories using FIFO method, whereas another entity may choose to value the same using Weighted Average method.

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While an entity is free to choose its accounting policy as long as in the financial statements reflect a true and fair view of the state of affairs of the enterprise as at the balance sheet date and of the profit or loss for the period ended, the application of different accounting policies by different entities affects the comparability of the financial statements of such different entities by stakeholders, analysts, investors etc. To mitigate the loss of comparability, Accounting Standard 1, Disclosure of Accounting Policies requires disclosure of significant accounting policies as a part of the financial statements. This would help users of the financial statements to understand the policies followed by different entities, particularly if they belong to the same industry, and make a correct analysis of each entity resulting in more informed decision-making.

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UNIT 2: ACCOUNTING STANDARD 3: CASH FLOW STATEMENT

LEARNING OUTCOMES

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

- What are Cash and Cash Equivalents
- Presentation of a Cash Flow Statement
- Reporting Cash Flows from Operating Activities
- Reporting Cash Flows from Investing and Financing Activities
- Reporting Cash Flows on a Net Basis
- Foreign Currency Cash Flows
- Extraordinary Items
- Interest and Dividends
- Taxes on Income
- Non-Cash Transactions.

2.1 INTRODUCTION

This Standard is mandatory for Non-SMCs (Non Small & Medium Companies) and the enterprises which fall in the category of Level I (for non-corporate entities), at the end of the relevant accounting period. For all other enterprises though it is not compulsory but it is encouraged to prepare such statements.

However, the Companies Act, 2013, mandates preparation of Cash flow statement by all companies except one person company, small company and dormant company (refer note below).

Where an enterprise was not covered by this statement during the previous year but qualifies in the current accounting year, they are not supposed to disclose the figures for the corresponding previous years. Whereas, if an enterprises qualifies under this statement to prepare the cash flow statements during the previous year but now disqualified, will continue to prepare cash flow statements for another two consecutive years.

Note : Under Section 129 of the Companies Act, 2013, the financial statement, with respect to One Person Company, small company and dormant company, may not include the cash flow statement. As per the Amendment, under Chapter I, clause (40) of section 2, an exemption has been provided vide Notification dated 13th June, 2017 under Section 462 of the Companies Act

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2013 to a start-up private company besides one person company, small company and dormant company. As per the amendment, a start-up private company is not required to include the cash flow statement in the financial statements.

Thus the financial statements, with respect to one Person Company, small company, dormant company and private company (if such a private company is a start-up), may not include the cash flow statement.

2.2 OBJECTIVE

Cash flow Statement (CFS) is an additional information provided to the users of accounts in the form of an statement, which reflects the various sources from where cash was generated (inflow of cash) by an enterprise during the relevant accounting year and how these inflows were utilised (outflow of cash) by the enterprise. This helps the users of accounts:

- To identify the historical changes in the flow of cash & cash equivalents.
- To determine the future requirement of cash & cash equivalents.
- To assess the ability to generate cash & cash equivalents.
- To estimate the further requirement of generating cash & cash equivalents.
- To compare the operational efficiency of different enterprises.
- To study the insolvency and liquidity position of an enterprise.
- As an indicator of amount, timing and certainty of future cash flows.
- To check the accuracy of past assessments of future cash flows
- In examining the relationship between profitability and net cash flow and the impact of changing prices.

2.3 MEANING OF THE TERM CASH AND CASH EQUIVALENTS FOR CASH FLOW STATEMENTS

Cash and cash equivalents for the purpose of cash flow statement consists of the following:

a. Cash in hand and deposits repayable on demand with any bank or other financial institutions and

b. Cash equivalents, which are short term, highly liquid investments that are readily convertible into known amounts of cash and are subject to insignificant risk of change in value. A short-term investment is one, which is due for maturity within three months from the date of acquisition. Investments in shares are not normally taken as cash equivalent, because of uncertainties associated with them as to realisable value.

Note: For the purpose of cash flow statement, 'cash and cash equivalent' consists of at least three balance sheet items, viz. cash in hand; demand deposits with banks and investments regarded as cash equivalents. For this reason, the AS 3 requires enterprises to give a break-up of opening and closing cash shown in their cash flow statements. This is presented as a note to cash flow statement.

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2.4 MEANING OF THE TERM CASH FLOW

Cash flows are inflows (i.e. receipts) and outflows (i.e. payments) of cash and cash equivalents. Any transaction, which does not result in cash flow, should not be reported in the cash flow statement. Movements within cash or cash equivalents are not cash flows because they do not change cash as defined by AS 3, which is sum of cash, bank and cash equivalents. For example, acquisitions of cash equivalent investments or cash deposited into bank are not cash flows.

It is important to note that a change in cash does not necessarily imply cash flow. For example: Suppose an enterprise has a bank balance of USD 10,000, stated in books at Rs.4,90,000 using the rate of exchange Rs.49/USD prevailing on date of receipt of dollars. If the closing rate of exchange is Rs.50/USD, the bank balance will be restated at Rs.5,00,000 on the balance sheet date. The increase is, however, not a cash flow because neither there is any cash inflow nor there is any cash outflow.

2.5 TYPES OF CASH FLOW

Cash flows for an enterprise occur in various ways, e.g. through operating income or expenses, by borrowing or repayment of borrowing or by acquisition or disposal of fixed assets. The implication of each type of cash flow is clearly different. Cash received on disposal of a useful fixed asset is likely to have adverse effect on future performance of the enterprise and it is completely different from cash received through operating income or cash received through borrowing. It may also be noted that implications of each cash flow types are interrelated. For example, borrowed cash used for meeting operating expenses is not same as borrowed cash used for acquisition of useful fixed assets.

For the aforesaid reasons, the standard identifies three types of cash flows, i.e.

i. operating cash flows;

ii. investing cash flows; and

iii. financing cash flows.

Separate presentation of each type of cash flow in the cash flow statement improves usefulness of cash flow information.

The **operating cash flows** are cash flows generated by operating activities or by other activities that are not investing or financing activities. Operating activities are the principal revenue-producing activities of the enterprise. Examples include, cash purchase and sale of goods, collections from customers for goods, payment to suppliers of goods, payment of salaries, wages etc.

The **investing cash flows** are cash flows generated by investing activities. The investing activities are the acquisition and disposal of long-term assets and other investments not included in cash equivalents. The examples of investing cash flows include cash flow arising from investing activities include: (a) receipts from disposals of fixed assets; (b) loan given to / recovered from other entities

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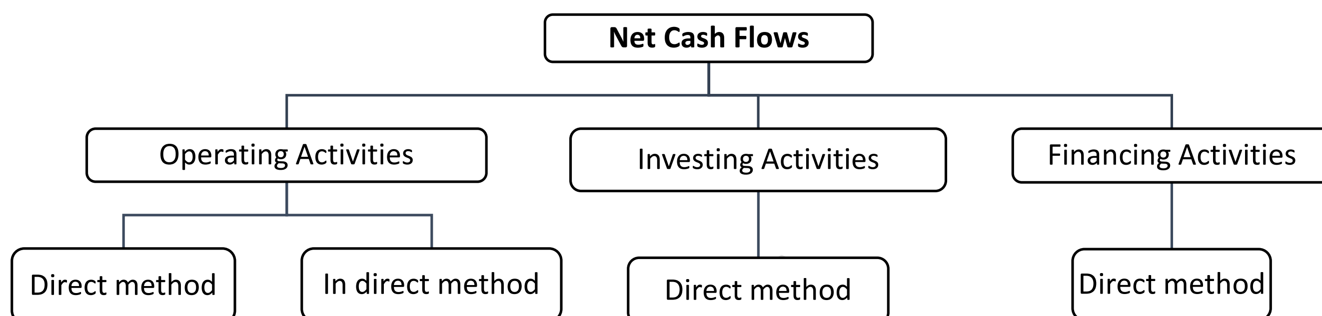
(other than loans by financial enterprises) (c) payments to acquire fixed assets (d) Interests and dividends earned (other than interests and dividends earned by financial institutions).

The **financing cash flows** are cash flows generated by financing activities. Financing activities are activities that result in changes in the size and composition of the owners' capital (including preferences share capital in the case of company) and borrowings of the enterprise. Examples include issue of shares / debentures, redemption of debentures / preference shares, payment of dividends and payment of interests (other than interests paid by financial institutions).

2.6 IDENTIFYING TYPE OF CASH FLOWS

Classification of Cash Flows



Cash flow type depends on the business of the enterprise and other factors. For example, since principal business of financial enterprises consists of borrowing, lending and investing, loans given and interests earned are operating cash flows for financial enterprises and investing cash flows for other enterprises. A few typical cases are discussed below.

2.6.1 Loans/Advances given and Interests earned

a. Loans and advances given and interests earned on them in the ordinary course of business are operating cash flows for financial enterprises.

b. Loans and advances given and interests earned on them are investing cash flows for non-financial enterprises.

c. Loans and advances given to subsidiaries and interests earned on them are investing cash flows for all enterprises.

d. Loans and advances given to employees and interests earned on them are operating cash flows for all enterprises.

e. Advance payments to suppliers and interests earned on them are operating cash flows for all enterprises.

f. Interests earned from customers for late payments are operating cash flows for non-financial enterprises.

2.6.2 Loans/Advances taken and interests paid

a. Loans and advances taken and interests paid on them in the ordinary course of business are operating cash flows for financial enterprises.

b. Loans and advances taken and interests paid on them are financing cash flows for non-financial enterprises.

c. Loans and advances taken from subsidiaries and interests paid on them are financing cash flows for all enterprises.

d. Advance taken from customers and interests paid on them are operating cash flows for non-financial enterprises.

e. Interests paid to suppliers for late payments are operating cash flows for all enterprises.

f. Interests taken as part of inventory costs in accordance with AS 16 are operating cash flows.

2.6.3 Investments made and dividends earned

a. Investments made and dividends earned on them in the ordinary course of business are operating cash flows for financial enterprises.

b. Investments made and dividends earned on them are investing cash flows for non-financial enterprises.

c. Investments in subsidiaries and dividends earned on them are investing cash flows for all enterprises.

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2.6.4 Dividends Paid

Dividends paid are financing cash outflows for all enterprises.

2.6.5 Income Tax

a. Tax paid on operating income is operating cash outflows for all enterprises

b. Tax deducted at source against income are operating cash outflows if concerned incomes are operating incomes and investing cash outflows if the concerned incomes are investment incomes, e.g. interest earned.

c. Tax deducted at source against expenses are operating cash inflows if concerned expenses are operating expenses and financing cash inflows if the concerned expenses are financing expenses, e.g. interests paid.

2.6.6 Insurance claims received

a. Insurance claims received against loss of stock or loss of profits are extraordinary operating cash inflows for all enterprises.

b. Insurance claims received against loss of fixed assets are extraordinary investing cash inflows for all enterprises.

AS 3 requires separate disclosure of extraordinary cash flows, classifying them as cash flows from operating, investing or financing activities, as may be appropriate.

2.7 REPORTING CASH FLOWS FROM OPERATING ACTIVITIES

Net cash flow from operating activities can be reported either as direct method or as indirect method.

In **'Direct method'** we take the gross receipts from sales, trade receivables and other operating inflows subtracted by gross payments for purchases, creditors and other expenses ignoring all non-cash items like depreciation, provisions.

In **'Indirect method'** we start from the net profit or loss figure, eliminate the effect of any non-cash items, investing items and financing items from such profit figure i.e. all such expenses like depreciation, provisions, interest paid, loss on sale of assets etc. are added and interest received etc. are deducted. Adjustment for changes in working capital items are also made ignoring cash and cash equivalent to reach to the figure of net cash flow.

Direct method is preferred over indirect because, direct method gives us the clear picture of various sources of cash inflows and outflows which helps in estimating the future cash inflows and outflows.

Below is the format for Cash Flow Statement (Illustrative):

Cash Flow Statement of X Ltd. for the year ended March 31, 20X1

(Direct Method)

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Particulars	Rs.	Rs.
Operating Activities:		
Cash received from sale of goods	xxx	
Cash received from Trade receivables	xxx	
Cash received from sale of services	xxx	xxx
Less: Payment for Cash Purchases	xxx	
Payment to Trade payables	xxx	
Payment for Operating Expenses	xxx	
(e.g. power, rent, electricity)		
Payment for wages & salaries	xxx	
Payment for Income Tax	xxx	xxx
		xxx
Adjustment for Extraordinary Items		xxx
Net Cash Flow from Operating Activities		xxx

Cash Flow Statement of X Ltd. for the year ended March 31, 20X1

(Indirect Method)

Particulars	Rs.	Rs.
Operating Activities:		
Closing balance of Profit & Loss Account	xxx	
Less: Opening balance of Profit & Loss Account	xxx	
	xxx	
Reversal of the effects of Profit & Loss Appropriation Account	xxx	
Add: Provision for Income Tax	xxx	
Effects of Extraordinary Items	xxx	
Net Profit Before Tax and Extraordinary Items	xxx	
Reversal of the effects of non-cash and non-operating items	xxx	
Effects for changes in Working Capital except cash & cash equivalent	xxx	
	xxx	
Less : Payment of Income Tax	xxx	xxx
Adjustment for Extraordinary Items		xxx
Net Cash Flow from Operating Activities		xxx

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Profit or loss on disposal of fixed assets

Profit or loss on sale of fixed asset is not operating cash flow. The entire proceeds of such transactions should be taken as cash inflow from investing activity.

Fundamental techniques of cash flow preparation

A cash flow statement is a summary of cash receipts and payments of an enterprise during an accounting period. Any attempt to compile such a summary from cashbooks is impractical due to the large volume of transactions. Fortunately, it is possible to compile such a summary by comparing financial statements at the beginning and end of accounting period.

2.8 REPORTING CASH FLOWS ON NET BASIS

AS 3 forbids netting of receipts and payments from investing and financing activities. Thus, cash paid on purchase of fixed assets should not be shown net of cash realised from sale of fixed assets. For example, if an enterprise pays Rs.50,000 in acquisition of machinery and realises Rs.10,000 on disposal of furniture, it is not right to show net cash outflow of Rs.40,000. The exceptions to this rule are stated below.

Cash flows from the following operating, investing or financing activities may be reported on a net basis.

a. Cash receipts and payments on behalf of customers, e.g. cash received and paid by a bank against acceptances and repayment of demand deposits.

b. Cash receipts and payments for items in which the turnover is quick, the amounts are large and the maturities are short, e.g. purchase and sale of investments by an investment company.

AS 3 permits financial enterprises to report cash flows on a net basis in the following three circumstances.

a. Cash flows on acceptance and repayment of fixed deposits with a fixed maturity date

b. Cash flows on placement and withdrawal deposits from other financial enterprises

c. Cash flows on advances/loans given to customers and repayments received there from.

Interest and Dividends

Cash flows from interest and dividends received and paid should each be disclosed separately. Cash flows arising from interest paid and interest and dividends received in the case of a financial enterprise should be classified as cash flows arising from operating activities. In the case of other enterprises, cash flows arising from interest paid should be classified as cash flows from financing activities while interest and dividends received should be classified as cash flows from investing activities. Dividends paid should be classified as cash flows from financing activities.

Non-Cash transactions Investing and financing transactions that do not require the use of cash or cash equivalents, e.g. issue of bonus shares, should be excluded from a cash flow statement. Such transactions should be disclosed elsewhere in the financial statements in a way that provides all the relevant information about these investing and financing activities.

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2.9 BUSINESS PURCHASE

The aggregate cash flows arising from acquisitions and disposals of subsidiaries or other business units should be presented separately and classified as cash flow from investing activities.

a. The cash flows from disposal and acquisition should not be netted off.

b. An enterprise should disclose, in aggregate, in respect of both acquisition and disposal of subsidiaries or other business units during the period each of the following:

   i. The total purchase or disposal consideration; and

   ii. The portion of the purchase or disposal consideration discharged by means of cash and cash equivalents.

Treatment of current assets and liabilities taken over on business purchase

Business purchase is not operating activity. Thus, while taking the differences between closing and opening current assets and liabilities for computation of operating cash flows, the closing balances should be reduced by the values of current assets and liabilities taken over. This ensures that the differences <u>reflect the increases/decreases in current assets and liabilities due to operating activities only.</u>

2.10 EXCHANGE GAINS AND LOSSES

The foreign currency monetary assets (e.g. balance with bank, debtors etc.) and liabilities (e.g. creditors) are initially recognised by translating them into reporting currency by the rate of exchange transaction date. On the balance sheet date, these are restated using the rate of exchange on the balance sheet date. The difference in values is exchange gain/loss. The exchange gains and losses are recognised in the statement of profit and loss.

The exchange gains/losses in respect of cash and cash equivalents in foreign currency (e.g. balance in foreign currency bank account) are recognised by the principle aforesaid, and these balances are restated in the balance sheet in reporting currency at rate of exchange on balance sheet date. The change in cash or cash equivalents due to exchange gains and losses are, however, not cash flows. This being so, the net increases/decreases in cash or cash equivalents in the cash flow statements are stated exclusive of exchange gains and losses. The resultant difference between cash and cash equivalents as per the cash flow statement and that recognised in the balance sheet is reconciled in the note on cash flow statement.

2.11 DISCLOSURES

AS 3 requires an enterprise to disclose the amount of significant cash and cash equivalent balances held by it but not available for its use, together with a commentary by management. This may happen for example, in case of bank balances held in other countries subject to such exchange control or other regulations that the fund is practically of no use.

AS 3 encourages disclosure of additional information, relevant for understanding the financial position and liquidity of the enterprise together with a commentary by management. Such information may include:

a. The amount of undrawn borrowing facilities that may be available for future operating activities and to settle capital commitments, indicating any restrictions on the use of these facilities; and

b. The aggregate amount of cash flows required for maintaining operating capacity, e.g. purchase of machinery to replace the old, separately from cash flows that represent increase in operating capacity, e.g. additional machinery purchased to increase production.

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ILLUSTRATIONS

Illustration 1

Classify the following activities as (a) Operating Activities, (b) Investing Activities, (c) Financing Activities (d) Cash Equivalents.

a. **Purchase of Machinery.**
b. **Proceeds from issuance of equity share capital**
c. **Cash Sales.**
d. **Proceeds from long-term borrowings.**
e. **Cheques collected from Trade receivables.**
f. **Cash receipts from Trade receivables.**
g. **Trading Commission received.**
h. **Purchase of investment.**
i. **Redemption of Preference Shares.**
j. **Cash Purchases.**
k. **Proceeds from sale of investment**
l. **Purchase of goodwill.**
m. **Cash paid to suppliers.**
n. **Interim Dividend paid on equity shares.**
o. **Wages and salaries paid.**
p. **Proceed from sale of patents.**
q. **Interest received on debentures held as investment.**
r. **Interest paid on Long-term borrowings.**
s. **Office and Administration Expenses paid**
t. **Manufacturing Overheads paid.**
u. **Dividend received on shares held as investments.**
v. **Rent Received on property held as investment.**
w. **Selling and distribution expense paid.**
x. **Income tax paid**
y. **Dividend paid on Preference shares.**
z. **Underwritings Commission paid.**
aa. **Rent paid.**
bb. **Brokerage paid on purchase of investments.**
cc. **Bank Overdraft**

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dd. **Cash Credit**

ee. **Short-term Deposits**

ff. **Highly liquid Marketable Securities (without risk of change in value)**

gg. **Refund of Income Tax received.**

Solution

a. Operating Activities: c, e, f, g, j, m, o, s, t, w, x, aa & gg.

b. Investing Activities: a, h, k, l, p, q, u, v, bb & ee.

c. Financing Activities: b, d, i, n, r, y, z, cc & dd.

d. Cash Equivalent: ff.

Illustration 2

X Ltd. purchased debentures of Rs.10 lakh of Y Ltd., which are redeemable within three months. How will you show this item as per AS 3 while preparing cash flow statement for the year ended on 31st March, 20X1?

Solution

As per AS 3 on 'Cash flow Statement', cash and cash equivalents consists of cash in hand, balance with banks and short-term, highly liquid investments∗ . If investment, of Rs.10 lakh, made in debentures is for short-term period then it is an item of 'cash equivalents'.

However, if investment of Rs.10 lakh made in debentures is for long-term period then as per AS 3, it should be shown as cash flow from investing activities.

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Illustration 3

Classify the following activities as per AS 3 Cash Flow Statement:

i. **Interest paid by financial enterprise**

ii. **Tax deducted at source on interest received from subsidiary company**

iii. **Deposit with Bank for a term of two years**

iv. **Insurance claim received towards loss of machinery by fire**

v. **Bad debts written off**

Solution

i. Interest paid by financial enterprise

Cash flows from operating activities

ii. TDS on interest received from subsidiary company

Cash flows from investing activities

iii. Deposit with bank for a term of two years

Cash flows from investing activities

iv. Insurance claim received against loss of fixed asset by fire

Extraordinary item to be shown as a separate heading under 'Cash flow from investing activities'

v. Bad debts written off

It is a non-cash item which is adjusted from net profit/loss under indirect method, to arrive at net cash flow from operating activity.

Illustration 4

Following is the cash flow abstract of Alpha Ltd. for the year ended 31st March, 20X1:

Cash Flow (Abstract)

Inflows	Rs.	Outflows	Rs.
Opening balance:		Payment for Account	
Cash	10,000	Payables	90,000
Bank	70,000	Salaries and wages	25,000
Share capital – shares issued	5,00,000	Payment of overheads	15,000
Collection on account of Trade		Property, plant and	
Receivables	3,50,000	equipment acquired	4,00,000
Sale of Property, plant and	70,000	Debentures redeemed	50,000
equipment		Bank loan repaid	2,50,000
		Taxation	55,000
		Dividends	1,00,000
		Closing balance:	
		Cash	5,000
		bank	10,000
	10,00,000		10,00,000

Prepare Cash Flow Statement for the year ended 31st March, 20X1 in accordance with Accounting Standard 3.

Solution

Cash Flow Statement for the year ended 31.3.20X1

	Rs.	Rs.
Cash flow from operating activities		
Cash received on account of trade receivables	3,50,000	
Cash paid on account of trade payables	(90,000)	
Cash paid to employees (salaries and wages)	(25,000)	
Other cash payments (overheads)	(15,000)	

Cash generated from operations	2,20,000	
Income tax paid	(55,000)	
Net cash generated from operating activities		1,65,000
Cash flow from investing activities		
Payment for purchase of Property, plant and equipment	(4,00,000)	
Proceeds from sale of Property, plant and equipment	70,000	
Net cash used in investment activities		(3,30,000)
Cash flow from financing activities		
Proceeds from issue of share capital	5,00,000	
Bank loan repaid	(2,50,000)	
Debentures redeemed	(50,000)	
Dividends paid	(1,00,000)	
Net cash used in financing activities		1,00,000
Net decrease in cash and cash equivalents		(65,000)
Cash and cash equivalents at the beginning of the year		80,000
Cash and cash equivalents at the end of the year		15,000

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Illustration 5

Prepare Cash Flow from Investing Activities of M/s. Creative Furnishings Limited for the year ended 31-3-20X1.

Particulars	Rs.
Plant acquired by the issue of 8% Debentures	**1,56,000**
Claim received for loss of plant in fire	**49,600**
Unsecured loans given to subsidiaries	**4,85,000**
Interest on loan received from subsidiary companies	**82,500**
Pre-acquisition dividend received on investment made	**62,400**
Debenture interest paid	**1,16,000**
Term loan repaid	**4,25,000**
Interest received on investment	**68,000**
(TDS of Rs. 8,200 was deducted on the above interest)	
Book value of plant sold (loss incurred Rs. 9,600)	**84,000**

Solution

Cash Flow Statement from Investing Activities of

M/s Creative Furnishings Limited for the year ended 31-03-20X1

Cash generated from investing activities	Rs.	Rs.
Interest on loan received	82,500	
Pre-acquisition dividend received on investment made	62,400	
Unsecured loans given to subsidiaries	(4,85,000)	
Interest received on investments (gross value)	76,200	
TDS deducted on interest	(8,200)	
Sale of plant	74,400	
Cash used in investing activities (before extra-ordinary item)		(1,97,700)
Extraordinary claim received for loss of plant		49,600
Net cash used in investing activities (after extra-ordinary item)		(1,48,100)

Note:

1. Debenture interest paid and Term Loan repaid are financing activities and, therefore, not considered for preparing cash flow from investing activities.
2. Plant acquired by issue of 8% debentures does not amount to cash outflow, hence also not considered in the above cash flow statement.

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Note: For details regarding preparation of Cash Flow Statement and Problems based on practical application of AS 3, students are advised to refer unit 2 of Chapter 11.

Reference: The students are advised to refer the full text of AS 3 “Cash Flow Statement.

TEST YOUR KNOWLEDGE

MCQs

1. **Crown Ltd. wants to prepare its cash flow statement. It sold equipment of book value of Rs.60,000 at a gain of Rs. 8,000. The amount to be reported in its cash flow statement under operating activities is**
   a. **Nil**
   b. **Rs. 8,000**
   c. **Rs. 68,000**
   d. **Rs. 60,000**

2. **While preparing cash flows statement, an entity (other than a financial institution) should disclose the dividends received from its investment in shares as**
   a. **operating cash inflow**
   b. **investing cash inflow**
   c. **financing cash inflow**
   d. **cash & cash equivalent**

3. **XYZ Co. is a financial enterprise. In its cash flow statement, interest paid and dividends received should be**
   a. **Classified as operating cash flows.**
   b. **Classified as financing cash flows.**
   c. **Not shown in cash flow statement.**
   d. **Classified as investing cash flows.**

4. **In the cash flow statement, 'cash and cash equivalents' do not include**
   a. **Bank balances**
   b. **Short-term investments readily convertible into Cash are subject to an insignificant risk of changes in value.**
   c. **Cash balances.**
   d. **Loan from bank.**

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

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b. **Gain on sale of a fixed asset.**

c. **Depreciation.**

d. **Gain on sale of inventory**

ANSWERS/HINTS

MCQs

1.	**a.**	Nil
2.	**b.**	investing cash inflow
3.	**a.**	Classified as operating cash flows.
4.	**d.**	Loan from bank.
5.	**d.**	Gain on sale of inventory

THEORETICAL QUESTIONS

Q.NO.1. What are the main features of the Cash Flow Statement?

ANSWER

According to AS 3 on "Cash Flow Statement", cash flow statement deals with the provision of information about the historical changes in cash and cash equivalents of an enterprise during the given period from operating, investing and financing activities. Cash flows from operating activities can be reported using either (a) the direct method, or (b) the indirect method. A cash flow statement when used in conjunction with the other financial statements, provides information that enables users to evaluate the changes in net assets of an enterprise, its financial structure (including its liquidity and solvency), and its ability to affect the amount and timing of cash flows in order to adapt to changing circumstances and opportunities.

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Q.NO.2. Mayuri Ltd. acquired Plant and Machinery for Rs. 25 lakh. During the same year, it also sold Furniture and Fixtures for Rs. 4 lakh. Can the company disclose, Net Cash Outflow towards purchase of Fixed Assets Rs. 21 lakh (i.e., 25 lakh – 4 lakh) in the Cash Flow Statement?

ANSWER

As per AS 3, Cash Flow Statements, an enterprise should report separately major classes of gross cash receipts and gross cash payments arising from investing and financing activities, except in the case of:

- cash receipts and payments on behalf of customers when the cash flows reflect the activities of the customer rather than those of the enterprise; and
- cash receipts and payments for items in which the turnover is quick, the amounts are large, and the maturities are short.

In the given case, since the purchase of Plant and Machinery and disposal of Furniture and Fixtures do not fall in the criteria of exception mentioned above, the same should be presented on a gross basis as an outflow of Rs. 25 lakh and an inflow of Rs. 4 lakh. Presentation of net cash outflow of Rs.21 lakh is not permitted as per AS 3.

PRACTICAL QUESTIONS

Q.NO.1. How would the following cash flows be classified in accordance with AS 3?

- **Corporate Income Tax paid amounting to Rs. 70 lakh during the reporting period.**
- **Payment of advance tax Rs. 8,75,000 out of which Rs. 75,000 was towards capital gains arising on account of sale of assets during the reporting period.**
- **Fixed Deposits withdrawn by customers of State Bank of India Rs. 3 crore.**

SOLUTION

As per AS 3, the given cash flows shall be recorded as under:

Corporate Income Tax paid amounting to Rs.70 lakh during the reporting period.	Rs.70 lakh: Operating Cash Flows
Payment of advance tax Rs.8,75,000 out of which Rs.75,000 was towards capital gains arising on account of sale of assets during the reporting period.	Rs.8,00,000: Operating Cash Flows Rs.75,000: Investing Cash Flows
Fixed Deposits withdrawn by customers of State Bank of India Rs.3 crore.	Rs.3 crore: Operating Cash Flows for State Bank of India.

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Q.NO.2. Money Ltd., a non-financial company has the following entries in its Bank Account. It has sought your advice on the treatment of the same for preparing Cash Flow Statement.

i. Loans and Advances given to the following and interest earned on them:

1. to suppliers

2. to employees

3. to its subsidiaries companies

ii. Investment made in subsidiary Smart Ltd. and dividend received

iii. Dividend paid for the year Discuss in the context of AS 3 Cash Flow Statement.

SOLUTION

Treatment as per AS 3 'Cash Flow Statement'

i. Loans and advances given and interest earned

1. to suppliers - Cash flows from operating activities

2. to employees - Cash flows from operating activities

3. to its subsidiary companies - Cash flows from investing activities

ii. Investment made in subsidiary company and dividend received

Cash flows from investing activities

iii. Dividend paid for the year

Cash flows from financing activities

Q.NO.3. From the following information of XYZ Limited, calculate cash and cash equivalent as on 31-03-20X2 as per AS 3.

Particulars	Amount (Rs.)
Balance as per the Bank Statement	**25,000**
Cheque issued but not presented in the Bank	**15,000**
Short Term Investment in liquid equity shares of ABC Limited	**50,000**
Fixed Deposit created on 01-11-20X1 and maturing on 15- 04-20X2	**75,000**
Short Term Investment in highly liquid Sovereign Debt Mutual fund on 01-03-20X2 (having maturity period of less than 3 months)	**1,00,000**
Bank Balance in a Foreign Currency Account in India	**$ 1,000**
(Conversion Rate: On the day of deposit Rs. 69/USD as on 31-03-20X2 Rs.70/USD)	

SOLUTION

Computation of Cash and Cash Equivalents as on 31st March, 20X2

	(Rs.)
Cash balance with bank (Rs. 25,000 less Rs. 15,000)	10,000
Short term investment in highly liquid sovereign debt mutual fund on 1.3.20X2	1,00,000
Bank balance in foreign currency account ($1,000 x Rs. 70)	70,000
	1,80,000

Note: Short term investment in liquid equity shares and fixed deposit will not be considered as cash and cash equivalents.

Q.NO.4. Z Ltd. has no Foreign Currency Cash Flow during the reporting period. It held a deposit in a bank in France. The balances as at the beginning of the year and at the end of the year were € 100,000 and € 105,000 respectively. The exchange rate at the beginning of the year was € 1 = Rs.82, and at the end of the year was € 1 = Rs. 85. The increase in the deposit balance of € 5,000 was on account of interest credited on the last day of the reporting period. The deposit was reported at Rs. 82,00,000 in the opening balance sheet and at Rs. 89,25,000 in the closing balance sheet. You are required to show+ how these transactions would be presented in the Cash Flow Statement as per AS 3.

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SOLUTION

The Statement of Profit and Loss was credited on account of:

Interest Income: € 5,000 x Rs.85 = Rs.4,25,000

Exchange difference = € 100,000 x (Rs.85 – Rs.82) = Rs.3,00,000

In preparing the Cash Flow Statement, the exchange difference of Rs.3,00,000 should be deducted from the Net Profit before taxes, since it is a non-cash item. However, in order to reconcile the opening balance of the Cash and Cash Equivalents with its closing balance, the Exchange Difference of Rs.3,00,000 should be added to the opening balance in a Note to the Cash Flow Statement,

Cash Flows arising from transactions in a Foreign Currency shall be recorded in Z Ltd's 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 cash flow.

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UNIT 3: ACCOUNTING STANDARD 17: SEGMENT REPORTING

LEARNING OUTCOMES

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

- Definition and Identification of Reportable Segments
- Primary and Secondary Segment Reporting Formats
- Business and Geographical Segments
- How to identify the Reportable Segments
- Disclosures.

3.1 INTRODUCTION

AS 17 is mandatory in respect of non-SMCs (and level I entities in case of non-corporate). Other entities are encouraged to comply with AS 17.

This standard establishes principles for reporting financial information about different types of products and services an enterprise produces and different geographical areas in which it operates. The standard is more relevant for assessing risks and returns of a diversified or multi-locational enterprise which may not be determinable from the aggregated data.

Before we start the standard, let us lay down the areas to be covered from the examination point of view.

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Identify the segments - Business or Geographical

Identify the Reportable Segments

Prepare a Segmental Report +Make appropriate Disclosures

3.2 OBJECTIVE

Many enterprises provide groups of products and services or operate in geographical areas that are subject to differing rates of profitability, opportunities for growth, future prospects, and risks. The objective of this Standard is to establish principles for reporting financial information, about the different types of products and services an enterprise produces and the different geographical areas in which it operates. Such information helps users of financial statements:

a. Better understand the performance of the enterprise;

b. Better assess the risks and returns of the enterprise; and

c. Make more informed judgements about the enterprise as a whole.

3.3 SCOPE

AS 17 should be applied in presenting general purpose financial statements.

An enterprise should comply with the requirements of this Standard fully and not selectively. If a single financial report contains both consolidated financial statements and separate financial statements of the parent, segment information need be presented only on the basis of the consolidated financial statements.

3.4 DEFINITION OF THE TERMS USED IN THE ACCOUNTING STANDARD

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

a. The nature of the products or services

b. The nature of the production processes

c. The type or class of customers for the products or services

d. The methods used to distribute the products or provide the services

e. If applicable, the nature of the regulatory environment, for example, banking, insurance, or public utilities

A single business segment does not include products and services with significantly differing risks and returns. While there may be dissimilarities with respect to one or several of the factors listed in the definition of business segment, the products and services included in a single business segment are expected to be similar with respect to a majority of the factors.

A **geographical segment** is a distinguishable component of an enterprise that is engaged in providing products or services within a particular economic environment and that is subject to risks and returns that are different from those of components operating in other economic environments. Factors that should be considered in identifying geographical segments include:

a. Similarity of economic and political conditions.

b. Relationships between operations in different geographical areas.

c. Proximity of operations.

d. Special risks associated with operations in a particular area.

e. Exchange control regulations and

f. The underlying currency risks.

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A single geographical segment does not include operations in economic environments with significantly differing risks and returns. A geographical segment may be a single country, a group of two or more countries, or a region within a country.

The risks and returns of an enterprise are influenced both by the geographical location of its operations (where its products are produced or where its service rendering activities are based) and also by the location of its customers (where its products are sold or services are rendered). The definition allows geographical segments to be based on either:

a. The location of production or service facilities and other assets of an enterprise; or

b. The location of its customers.

The predominant sources of risks affect how most enterprises are organised and managed. Therefore, the organisational structure of an enterprise and its internal financial reporting system are normally the basis for identifying its segments.

A reportable segment is a business segment or a geographical segment identified on the basis of foregoing definitions for which segment information is required to be disclosed by AS 17.

Segment revenue is the aggregate of

i. The portion of enterprise revenue that is directly attributable to a segment;

ii. The relevant portion of enterprise revenue that can be allocated on a reasonable basis to a segment; and

iii. Revenue from transactions with other segments of the enterprise.

Segment revenue does not include:

a. Extraordinary items as defined in AS 5;

b. Interest or dividend income, including interest earned on advances or loans to other segments unless the operations of the segment are primarily of a financial nature; and

c. Gains on sales of investments or on extinguishment of debt unless the operations of the segment are primarily of a financial nature.

Segment expense is the aggregate of

i. The expense resulting from the operating activities of a segment that is directly attributable to the segment;

ii. The relevant portion of enterprise expense that can be allocated on a reasonable basis to the segment; and

iii. Including expense relating to transactions with other segments of the enterprise.

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Segment expense does not include:

a. Extraordinary items as defined in AS 5;

b. Interest expense, including interest incurred on advances or loans from other segments, unless the operations of the segment are primarily of a financial nature;

c. Losses on sales of investments or losses on extinguishment of debt unless the operations of the segment are primarily of a financial nature;

d. Income tax expense; and

e. General administrative expenses, head-office expenses, and other expenses that arise at the enterprise level and relate to the enterprise as a whole. However, costs are sometimes incurred at the enterprise level on behalf of a segment. Such costs are part of segment expense if they relate to the operating activities of the segment and if they can be directly attributed or allocated to the segment on a reasonable basis.

Segment result is segment revenue less segment expense.

Segment assets are those operating assets that are employed by a segment in its operating activities and that either are directly attributable to the segment or can be allocated to the segment on a reasonable basis.

If the segment result of a segment includes interest or dividend income, its segment assets include the related receivables, loans, investments, or other interest or dividend generating assets.

Segment assets do not include:

- income tax assets; and
- assets used for general enterprise or head-office purposes.

Segment assets are determined after deducting related allowances/provisions that are reported as direct offsets in the balance sheet of the enterprise.

Segment liabilities are those operating liabilities that result from the operating activities of a segment and that either are directly attributable to the segment or can be allocated to the segment on a reasonable basis.

If the segment result of a segment includes interest expense, its segment liabilities include the related interest-bearing liabilities.

Examples of segment liabilities include trade and other payables, accrued liabilities, customer advances, product warranty provisions, and other claims relating to the provision of goods and services.

Segment liabilities do not include:

- income tax liabilities; and
- borrowings and other liabilities that are incurred for financing rather than operating purposes.

Assets and liabilities that relate jointly to two or more segment should be allocated to segments if, and only if, their related revenues and expenses also are allocated to those segments.

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3.5 TREATMENT OF INTEREST FOR DETERMINING SEGMENT EXPENSE

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

In case interest is included as a part of the cost of inventories where it is so required as per AS 16, read with AS 2 (Revised), and those inventories are part of segment assets of a particular segment, such interest should be considered as a segment expense. In this case, the amount of such interest and the fact that the segment result has been arrived at after considering such interest should be disclosed by way of a note to the segment result.

3.6 ALLOCATION

An enterprise looks to its internal financial reporting system as the starting point for identifying those items that can be directly attributed, or reasonably allocated, to segments. There is thus a presumption that amounts that have been identified with segments for internal financial reporting purposes are directly attributable or reasonably allocable to segments for the purpose of measuring the segment revenue, segment expense, segment assets, and segment liabilities of reportable segments.

In some cases, however, a revenue, expense, asset or liability may have been allocated to segments for internal financial reporting purposes on a basis that is understood by enterprise management but that could be deemed arbitrary in the perception of external users of financial statements. Conversely, an enterprise may choose not to allocate some item of revenue, expense, asset or liability for internal financial reporting purposes, even though a reasonable basis for doing so exists. Such an item is allocated pursuant to the definitions of segment revenue, segment expense, segment assets, and segment liabilities in AS 17.

Segment revenue, segment expense, segment assets and segment liabilities are determined before intra-enterprise balances and intra-enterprise transactions are eliminated as part of the process of preparation of enterprise financial statements, except to the extent that such intra-enterprise balances and transactions are within a single segment.

While the accounting policies used in preparing and presenting the financial statements of the enterprise as a whole are also the fundamental segment accounting policies, segment accounting policies include, in addition, policies that relate specifically to segment reporting, such as identification of segments, method of pricing inter-segment transfers, and basis for allocating revenues and expenses to segments.

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3.7 PRIMARY AND SECONDARY SEGMENT REPORTING FORMATS

The dominant source and nature of risks and returns of an enterprise should govern whether its primary segment reporting format will be business segments or geographical segments.

If the risks and returns of an enterprise are affected predominantly by differences in the products and services it produces, its primary format for reporting segment information should be business segments, with secondary information reported geographically. Similarly, if the risks and returns of the enterprise are affected by the fact that it operates in different countries or other geographical areas, its primary format for reporting segment information should be geographical segments, with secondary information reported for groups of related products and services.

3.8 BUSINESS AND GEOGRAPHICAL SEGMENTS

Generally, business and geographical segments are determined on the basis of internal financial reporting to the board of directors and the Chief Executive Officer. But if such segment does not satisfy the definitions given in AS, then following points should be considered:

a. If one or more of the segments reported internally to the directors and management is a business segment or a geographical segment based on the factors in the definitions but others are not, paragraph below should be applied only to those internal segments that do not meet the definitions (that is, an internally reported segment that meets the definition should not be further segmented).

b. For those segments reported internally to the directors and management that do not satisfy the definitions, management of the enterprise should look to the next lower level of internal segmentation that reports information along product and service lines or geographical lines, as appropriate under the definitions and

c. If such an internally reported lower-level segment meets the definition of business segment or geographical segment, the criteria for identifying reportable segments should be applied to that segment.

3.9 IDENTIFYING REPORTABLE SEGMENTS (QUANTITATIVE THRESHOLDS)

A business segment or geographical segment should be identified as a reportable segment if:

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

b. Its segment result, whether profit or loss, is 10% or more of –

  i. The combined result of all segments in profit, or

  ii. The combined result of all segments in loss,

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Whichever is greater in absolute amount; or

c. Its segment assets are 10% or more of the total assets of all segments. A business segment or a geographical segment which is not a reportable segment as per above paragraph, may be designated as a reportable segment despite its size at the discretion of the management of the enterprise. If that segment is not designated as a reportable segment, it should be included as an unallocated reconciling item.

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

We can summarize the steps as under:

Step I – Apply 10% Test (Materiality Test):

Any 1 Test needs to be met – For Reportable Segment:	
Revenue Test	Revenue (External + Internal) of the segment is 10% or more of the Total Revenue of all segments
Profit/Loss Test	**Case I – All segments have profits:** Profit of the segment is 10% or more of the total profit of all segments
	Case II – Few segments have profit + Few segments have losses: **1.** Add the profits of profitable segments only. **2.** Add the losses of loss-making segments only. **3.** Take the figure (from 1 and 2) whichever is greater (in absolute values). **4.** The segment which has profit/loss equal to 10% or more of the absolute figure computed in Point 3 becomes reportable.
Asset Test	The segment assets are 10% or more of the total assets of all segments.
Note: A business segment or a geographical segment which is not a reportable segment as per above steps, **may be designated** as a reportable segment despite its size at the **discretion of the management** of the enterprise.	

Step II – Apply 75% Test (Overall Test):

Ensure that the **total external revenue** attributable to reportable segments constitutes at least 75% of the **total enterprise revenue**.

If not, additional segments should be identified as reportable segments, even if they do not meet the 10% thresholds, until at least 75% of total enterprise revenue is included in reportable segments.

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Notes:

1. A segment identified as a reportable segment in the immediately preceding period because it satisfied the relevant 10% thresholds should continue to be a reportable segment for the current period notwithstanding that its revenue, result, and assets all no longer meet the 10% thresholds.
2. If a segment is identified as a reportable segment in the current period because it satisfies the relevant 10% thresholds, preceding-period segment data that is presented for comparative purposes should, unless it is impracticable to do so, be restated to reflect the newly reportable segment as a separate segment, even if that segment did not satisfy the 10% thresholds in the preceding period.

3.10 SEGMENT ACCOUNTING POLICIES

Segment information should be prepared in conformity with the accounting policies adopted for preparing and presenting the financial statements of the enterprise as a whole. AS 17 does not prohibit the disclosure of additional segment information that is prepared on a basis other than the accounting policies adopted for the enterprise financial statements provided that-

a. the information is reported internally to the board of directors and the chief executive officer for purposes of making decisions about allocating resources to the segment and assessing its performance; and
b. the basis of measurement for this additional information is clearly described.

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3.11 PRIMARY REPORTING FORMAT

An enterprise should disclose the following for each reportable segment:

a. Segment revenue, classified into segment revenue from sales to external customers and segment revenue from transactions with other segments;
b. Segment result;
c. Total carrying amount of segment assets;
d. Total amount of segment liabilities;
e. Total cost incurred during the period to acquire segment assets that are expected to be used during more than one period (tangible and intangible fixed assets);
f. Total amount of expense included in the segment result for depreciation and amortisation in respect of segment assets for the period; and
g. Total amount of significant non-cash expenses, other than depreciation and amortisation in respect of segment assets that were included in segment expense and, therefore, deducted in measuring segment result.

An enterprise that reports the amount of cash flows arising from operating, investing and financing activities of a segment need not disclose depreciation and amortisation expense and non-cash expenses.

An enterprise should present a reconciliation between the information disclosed for reportable segments and the aggregated information in the enterprise financial statements.

In presenting the reconciliation:

- segment revenue should be reconciled to enterprise revenue;
- segment result should be reconciled to enterprise net profit or loss;
- segment assets should be reconciled to enterprise assets; and
- segment liabilities should be reconciled to enterprise liabilities.

3.12 SECONDARY SEGMENT INFORMATION

If primary format of an enterprise for reporting segment information is business segments, it should also report the following information:

a. Segment revenue from external customers by geographical area based on the geographical location of its customers, for each geographical segment whose revenue from sales to external customers is 10% or more of enterprise revenue;

b. The total carrying amount of segment assets by geographical location of assets, for each geographical segment whose segment assets are 10% or more of the total assets of all geographical segments; and

c. The total cost incurred during the period to acquire segment assets that are expected to be used during more than one period (tangible and intangible fixed assets) by geographical location of assets, for each geographical segment whose segment assets are 10% or more of the total assets of all geographical segments.

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If primary format of an enterprise for reporting segment information is geographical segments (whether based on location of assets or location of customers), it should also report the following segment information for each business segment whose revenue from sales to external customers is 10% or more of enterprise revenue or whose segment assets are 10% or more of the total assets of all business segments:

a. Segment revenue from external customers;

b. The total carrying amount of segment assets; and

c. The total cost incurred during the period to acquire segment assets that are expected to be used during more than one period (tangible and intangible fixed assets).

3.13 OTHER DISCLOSURES

In measuring and reporting segment revenue from transactions with other segments, inter-segment transfers should be measured on the basis that the enterprise actually used to price those transfers. The basis of pricing inter-segment transfers and any change therein should be disclosed in the financial statements.

Changes in accounting policies adopted for segment reporting that have a material effect on segment information should be disclosed. Such disclosure should include a description of the nature of the change, and the financial effect of the change if it is reasonably determinable.

Some changes in accounting policies may relate specifically to segment reporting.

- Example could be: changes in identification of segments; and
- changes in the basis for allocating revenues and expenses to segments.

Such changes can have a significant impact on the segment information reported but will not change aggregate financial information reported for the enterprise. To enable users to understand the impact of such changes, this Standard requires the disclosure of the nature of the change and the financial effects of the change, if reasonably determinable.

An enterprise should indicate the types of products and services included in each reported business segment and indicate the composition of each reported geographical segment, both primary and secondary, if not otherwise disclosed in the financial statements.

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ILLUSTRATIONS

Illustration 1

The Chief Accountant of Sports Ltd. gives the following data regarding its six segments:

Rs. in lakh

Particulars	M	N	O	P	Q	R	Total
Segment Assets	**40**	**80**	**30**	**20**	**20**	**10**	**200**
Segment Results	**50**	**(190)**	**10**	**10**	**(10)**	**30**	**(100)**
Segment Revenue	**300**	**620**	**80**	**60**	**80**	**60**	**1,200**

The Chief accountant is of the opinion that segments "M" and "N" alone should be reported. Is he justified in his view? Discuss.

Solution

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

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

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

- The combined result of all segments in profit; or
- The combined result of all segments in loss,

whichever is greater in absolute amount; or

Its segment assets are 10% or more of the total assets of all segments.

If the total external revenue attributable to reportable segments constitutes less than 75% of total enterprise revenue, additional segments should be identified as reportable segments even if they do not meet the 10% thresholds until atleast 75% of total enterprise revenue is included in reportable segments. On the basis of turnover criteria segments M and N are reportable segments.

On the basis of the result criteria, segments M, N and R are reportable segments

(since their results in absolute amount is 10% or more of Rs. 200 lakh).

On the basis of asset criteria, all segments except R are reportable segments.

Since all the segments are covered in at least one of the above criteria, all segments have to be reported in accordance with Accounting Standard (AS) 17. Hence the opinion of chief accountant is wrong.

Illustration 2

A Company has an inter-segment transfer pricing policy of charging at cost less 10%. The market prices are generally 25% above cost. Is the policy adopted by the company correct?

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Solution

AS 17 'Segment Reporting' requires that inter-segment transfers should be measured on the basis that the enterprise actually used to price these transfers. The basis of pricing inter-segment transfers and any change therein should be disclosed in the financial statements. Hence the enterprise can have its own policy for pricing inter-segment transfers and hence inter-segment transfers may be based on cost, below cost or market price. However, whichever policy is followed, the same should be disclosed and applied consistently. Therefore, in the given case inter-segment transfer pricing policy adopted by the company is correct if, followed consistently.

Illustration 3

M/s XYZ Ltd. has three segments namely X, Y, Z. The total Assets of the Company are Rs. 10.00 crores. Segment X has Rs. 2.00 crores, segment Y has Rs. 3.00 crores and segment Z has Rs. 5.00 crores. Deferred tax assets included in the assets of each segments are X- Rs. 0.50 crores, Y—Rs. 0.40 crores and Z—Rs. 0.30 crores. The accountant contends that all the three segments are reportable segments. Comment.

Solution

According to AS 17 "Segment Reporting", segment assets do not include income tax assets. Therefore, the revised total assets are Rs. 8.8 crores [Rs. 10 crores – (Rs. 0.5 + Rs. 0.4 +Rs. 0.3)].
Segment X holds total assets of Rs. 1.5 crores (Rs. 2 crores –Rs. 0.5 crores);
Segment Y holds Rs. 2.6 crores (Rs. 3 crores –Rs. 0.4 crores); and
Segment Z holds Rs. 4.7 crores (Rs. 5 crores –Rs. 0.3 crores).
Thus all the three segments hold more than 10% of the total assets, all segments are reportable segments.

Illustration 4

Prepare a segmental report for publication in Diversifiers Ltd. from the following details of the company's three divisions and the head office:

	Rs. ('000)
Forging Shop Division	
Sales to Bright Bar Division	**4,575**
Other Domestic Sales	**90**
Export Sales	**6,135**
	10,800
Bright Bar Division	
Sales to Fitting Division	**45**

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Export Sales to Rwanda	**300**
	345
Fitting Division	
Export Sales to Maldives	**270**

Particulars	**Head Office Rs. ('000)**	**Forging Shop Division Rs. ('000)**	**Bright Bar Division Rs. ('000)**	**Fitting Division Rs. ('000)**
Pre-tax operating result		**240**	**30**	**(12)**
Head office cost reallocated		**72**	**36**	**36**
Interest costs		**6**	**8**	**2**
Fixed assets	**75**	**300**	**60**	**180**
Net current assets	**72**	**180**	**60**	**135**
Long-term liabilities	**57**	**30**	**15**	**180**

Solution

Diversifiers Ltd.

Segmental Report

(Rs. '000)

Particulars	**Divisions**			**Inter Segment Eliminations**	**Consolidated Total**
	Forging shop	**Bright Bar**	**Fitting**		
Segment Revenue					
Sales:					
Domestic	90	–	–	–	90
Export	6,135	300	270	–	6,705
External Sales	6,225	300	270	–	6,795
Inter-Segment Sales	4,575	45	–	4,620	–
Total Revenue	10,800	345	270	4,620	6,795
Segment Result (Given)	240	30	(12)		258
Head Office Expenses					(144)
Operating Profit					114
Interest Expense					(16)
Profit Before Tax					98

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Information in Relation to Assets and Liabilities:					
Fixed Assets	300	60	180	–	540
Net Current Assets	180	60	135	–	375
Segment assets	480	120	315	–	915
Unallocated Corporate Assets (75 + 72)	–	–	–	–	147
Total assets					1,062
Segment liabilities	30	15	180	–	225
Unallocated corporate liabilities					57
Total liabilities					282

Sales Revenue by Geographical Market

(Rs. '000)

	Home Sales	**Export Sales (by forging shop division)**	**Export to Rwanda**	**Export to Maldives**	**Consolidated Total**
External sales	90	6,135	300	270	6,795

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Illustration 5

Microtech Ltd. produces batteries for scooters, cars, trucks, and specialised batteries for invertors and UPS. How many segments should it have and why?

Solution

In case of Microtech Ltd., the basic product is the batteries, but the risks and returns of the batteries for automobiles (scooters, cars and trucks) and batteries for invertors and UPS are affected by different set of factors. In case of automobile batteries, the risks and returns are affected by the Government policy, road conditions, quality of automobiles, etc. whereas in case of batteries for invertors and UPS, the risks and returns are affected by power condition, standard of living, etc. Therefore, it can be said that Microtech Ltd. has two business segments viz- 'Automobile batteries' and 'batteries for Invertors and UPS'.

Reference: The students are advised to refer the full text of AS 17 "Segment Reporting".

TEST YOUR KNOWLEDGE

MCQs

1. **As per AS 17, reportable segments are those whose total revenue from external sales and inter-segment sales is**
   a. **10% or more of the total revenue of all segments**
   b. **10% or more of the total revenue of all external segments**
   c. **12% or more of the total revenue of all segments**
   d. **12% or more of the total revenue of all external segments**

2. **Which of the following statements is correct?**
   a. **Management has a discretion to include a segment as a reportable segment even if it passes the 10% materiality test.**
   b. **Management has a discretion to include any segment as a reportable segment if it fails the 12% materiality test.**
   c. **It is mandatory for the management to include the segment as a reportable segment if it passes the 10% materiality test.**
   d. **It is not mandatory for the management to include the segment as a reportable segment if it passes the 10% materiality test.**

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3. **Which of the following statements is correct?**
   a. **The overall test of 75% considers only external revenue to compute the threshold limit.**
   b. **The overall test of 75% considers only internal revenue to compute the threshold limit.**
   c. **The overall test of 75% considers both internal and external revenue to compute the threshold limit.**
   d. **It is management choice whether they want to include both external and internal revenue for computing threshold limit.**

4. **Which of the following statements is correct?**
   a. **The 10% test computed on the basis of revenue, considers both internal and external revenue to compute the threshold limit.**
   b. **The 10% test computed on the basis of revenue, considers only external revenue to compute the threshold limit.**
   c. **The 10% test computed on the basis of revenue, considers only internal revenue to compute the threshold limit.**

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

5. Which of the following statements is correct?

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

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

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

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

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ANSWERS/ HINTS

MCQs

1.	**a.**	10% or more of the total revenue of all segments
2.	**c.**	It is mandatory for the management to include the segment as a reportable segment if it passes the 10% materiality test.
3.	**a.**	The overall test of 75% considers only external revenue to compute the threshold limit.
4.	**a.**	The 10% test computed on the basis of revenue, considers both internal and external revenue to compute the threshold limit.
5.	**c.**	In case of 10% test based on profit/loss, we need to consider that any segment whose profit or loss is 10% or more than the net profit or loss (whichever is higher in absolute figures) of all segments taken together becomes reportable segment.

PRACTICAL QUESTIONS

Q.NO.1. Nathan Limited has three segments namely P, Q and R. The assets of the company are Rs. 15 crores. Segment P has 4 crores, Segment Q has 6 crores and Segment R has 5 crores. Deferred tax assets included in the assets of each segment are P - Rs. 1 crore, Q - Rs. 0.90 crores and R - Rs. 0.80 crores. The accountant contends all these three segments are reportable segments. Comment.

ANSWER

According to AS 17 "Segment Reporting", segment assets do not include income tax assets. Therefore, the revised total assets are 12.3 crores [Rs. 15 - (Rs. 1 +0.9 + 0.8).

Details of Segment wise assets:

Segment P holds total assets of Rs. 3 crores (Rs. 4 crores - Rs. 1 crores);

Segment Q holds Rs. 5.1 crores (Rs. 6 crores - Rs. 0.9 crores);

Segment R holds Rs. 4.2 crores (Rs. 5 crores - Rs. 0.8 crores).

Thus, all the three segments hold more than 10% of the total assets, all segments are reportable segments.

Hence, the contention of the Accountant that all three segments are reportable segments is correct.

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Q.NO.2. Company A is engaged in the manufacture and sale of products, which constitute two distinct business segments. The products of the Company are sold in the domestic market only. The management information system of the Company is organized to reflect operating information by two broad market segments, rural and urban.

ANSWER

AS 17 explains that, "a single geographical segment does not include operations in economic environments with significantly differing risks and returns. A geographical segment may be a single country, a group of two or more countries, or a region within a country".

Accordingly, to identity geographical segments, Company A needs to evaluate whether the segments reflected in the management information system function in environments that are subject to significantly differing risks and returns irrespective of the fact whether they are within the same country. The Standard recognizes that, "Determining the composition of a business or geographical segment involves a certain amount of judgement…". Accordingly, while the management information system of the Company provides segment information for rural and urban geographical segments for the purpose of internal reporting, judgement is required to determine whether these segments are subject to significantly differing risks and returns based on the definition of geographical segment. In making such a judgement, aspect like different pricing and other policies, e.g., credit policies,

deployment of resources between different regions etc., may be considered for the purpose identifying ‘urban and ‘rural’ as separate geographical segment.

Company A, in making judgment for identifying geographical segments, should also consider the relevance, reliability and comparability over time of segment information that will be reported. The Standard, explains that, “In making that judgement, enterprise management takes into account the objective of reporting financial information by segment as set forth in the standard and the qualitative characteristics of financial statements. The qualitative characteristics include the relevance, reliability and comparability over time of financial information that is reported about the different groups of products and services of an enterprise and about its operations in particular geographical areas, and the usefulness of that information for assessing the risks and returns of the enterprise.”

Q.NO.3. PK Ltd. has identified business segment as its primary reporting format. It has identified India, USA and UK as three geographical segments. It sells its products in the Indian market, which constitutes 70 percent of the Company’s sales. 25 per cent is sold in USA and the balance is sold in UK. Is PK Ltd. as part of its geographical secondary segment information, required to disclose segment revenue from export sales, where such sales are not significant?

ANSWER

As per AS 17, if primary format of an enterprise for reporting segment information is business segments, it should also report segment revenue from external customers by geographical area based on the geographical location of its customers, for each geographical segment whose revenue from sales to external customers is 10 per cent or more of enterprise revenue. Therefore, for the purposes of disclosing secondary segment information, PK Ltd. is not required to disclose segment revenue from export sales to UK, since that segment does not meet the 10 per cent or more of enterprise revenue threshold. However, other secondary segment information as per AS 17 should be disclosed in respect of this segment if the thresholds prescribed in the AS 17 are met.

Q.NO.4. XYZ Ltd. has 5 business segments. Profit / Loss of each of the segments for the year ended 31st March, 20X2 have been provided below. You are required to identify from the following whether reportable segments or not reportable segments, on the basis of "profitability test" as per AS-17.

Segment	Profit (Loss) Rs. in lakhs
A	225
B	25
C	(175)
D	(20)
E	(105)

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ANSWER

As per AS 17 'Segment Reporting', a business segment or geographical segment should be identified as a reportable segment if: Its segment results whether profit or loss is 10% or more of:

- The combined result of all segments in profit; i.e. Rs. 250 Lakhs or
- The combined result of all segments in loss; i.e. Rs. 300 Lakhs

Whichever is greater in absolute amount i.e. Rs. 300 Lakhs.

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

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

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Q.NO.5. ABC Limited has 5 segments namely A, B, C, D and E. The profit/loss of each segment for the year ended March 31st, 20X2 is as follows:

Segment	Profit /(Loss) (Rs. in crore)
A	**780**
B	**1,500**
C	**(2,300)**
D	**(4,500)**
E	**6,000**
Total	**1,480**

Identify the Reportable segments.

ANSWER

In compliance with AS 17, the segment profit/loss of respective segment will be compared with the greater of the following:

i. All segments in profit, i.e., A, B and E - Total profit Rs. 8,280 crores.

ii. All segments in loss, i.e., C and D - Total loss Rs. 6,800 crores.

Greater of the above - Rs. 8,280 crores.

Based on the above, reportable segments will be determined as follows:

Segment	Profit/(Loss)	Absolute Profit/Loss as a % of 8,280	Reportable Segment
A	780	9%	No
B	1,500	18%	Yes
C	(2,300)	28%	Yes
D	(4,500)	54%	Yes
E	6,000	72%	Yes
Total	**1,480**		

Q.NO.6. Heavy Goods Ltd. has 6 segments namely L-Q (below). The total revenues (internal and external), profits or losses and assets are set out below: (In Rs.)

Segment	Inter Segment Sales	External Sales	Profit / loss	Total assets
L	**4,200**	**12,300**	**3,000**	**37,500**
M	**3,500**	**7,750**	**1,500**	**23,250**
N	**1,000**	**3,500**	**(1,500)**	**15,750**
0	**0**	**5,250**	**(750)**	**10,500**
P	**500**	**5,500**	**900**	**10,500**
Q	**1,200**	**1,050**	**600**	**5,250**
	10,400	**35,350**	**3,750**	**1,02,750**

Heavy Goods Ltd. needs to determine how many reportable segments it has. You are required to advice Heavy Goods Ltd. as per the criteria defined in AS 17.

ANSWER

Quantitative Threshold Test:

Revenue Test:

Combined total sales of all the segment = Rs. 10,400 + Rs. 35,350 = Rs. 45,750.

10% thresholds = 45,750 x 10% = 4,575.

Profitability Test:

In the given situation, combined reported profit = Rs. 6,000 and combined reported loss (Rs. 2,250).

Hence, for 10% thresholds Rs. 6,000 will be considered.

10% thresholds = Rs. 6,000 x 10% = Rs. 600

Asset Test: Combined total assets of all the segment = Rs. 1,02,750

10% thresholds = Rs. 1,02,750 x 10% = 10,275

Accordingly, quantitative thresholds are calculated below:

Segments	L	M	N	O	P	Q	Reportable segments
% segment sales to total sales	36.66%	24.59%	9.84%	11.48%	13.11%	4.92%	L, M,O,P
% segment profit to total profits	50%	25%	25%	12.5%	15%	10%	L,M,N,O,P,Q
% segment assets to total assets	36.50%	22.63%	15.33%	10.22%	10.22%	5.11%	L,M,N,O,P

Conclusion:

Segments L, M, O and P clearly satisfy the revenue and assets tests and they are separate reportable segments.

Segment N does not satisfy the revenue test, but it does satisfy the asset test and it is a reportable segment.

Segment Q does not satisfy the revenue or the assets test but is does satisfy the profits test. Therefore, Segment Q is also a reportable segment.

Hence all segments i.e. L, M, N, O, P and Q are reportable segments.

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Q.NO.7. Calculate the segment results of a manufacturing organization from the following information:

Segments	A	B	C	Total
Directly attributed revenue	**5,00,000**	**3,00,000**	**1,00,000**	**9,00,000**
Enterprise revenue (allocated in 5 :4 : 2 basis)				**1,10,000**
Revenue from transactions with other segments				
Transaction from B	**1,00,000**		**50,000**	**1,50,000**
Transaction from C	**10,000**	**50,000**		**60,000**
Transaction from A		**25,000**	**1,00,000**	**1,25,000**
Operating expenses	**3,00,000**	**1,50,000**	**75,000**	**5,25,000**
Enterprise expenses (allocated in 5 :4 :2 basis)				**77,000**
Expenses on transactions				

with other segments				
Transaction from B	**75,000**		**30,000**	
Transaction from C	**6,000**	**40,000**		
Transaction from A		**18,000**	**82,000**	

ANSWER

Computation of segment result:

Segments	A	B	C	Total
Directly attributed revenue	5,00,000	3,00,000	1,00,000	9,00,000
Enterprise revenue	50,000	40,000	20,000	1,10,000
(allocated in 5 :4 : 2 basis)				
Revenue from transactions with				
other segments				
Transaction from B	1,00,000		50,000	1,50,000
Transaction from C	10,000	50,000		60,000
Transaction from A		25,000	1,00,000	1,25,000
Total segment revenue (1)	**6,60,000**	**4,15,000**	**2.70,000**	**13,45,000**
Operating expenses	3,00,000	1,50,000	75,000	5,25,000
Enterprise expenses	35,000	28,000	14,000	77,000
(allocated in 5 :4 :2 basis)				
Expenses on transactions with				
other segments				
Transaction from B	75,000		30,000	1,05,000
Transaction from C	6,000	40,000		46,000
Transaction from A		18,000	82,000	1,00,000
Total segment expenses (2)	**4,16,000**	**2,36,000**	**2,01,000**	**8,53,000**
Segment result (1-2)	**2,44,000**	**1,79,000**	**69,000**	**4,92,000**

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UNIT 4: ACCOUNTING STANDARD 18: RELATED PARTY DISCLOSURES

LEARNING OUTCOMES

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

- Need for disclosure of related party relationship;
- How to identify the related party relationships;
- Which parties are not treated as related party;
- Exemption from Related Party Disclosure in certain situations;
- Disclosure requirements under AS-18.

4.1 INTRODUCTION

AS 18 prescribes the requirements for disclosure of related party relationship and transactions between the reporting enterprise and its related parties. The requirements of the standard apply to the financial statements of each reporting enterprise as also to consolidated financial statements presented by a holding company.

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4.2 RELATED PARTY ISSUE – WHY DISCLOSURE IS NEEDED?

Related party relationships are a normal feature of commerce and business.

There is a general presumption that transactions reflected in financial statements are consummated on an arm's-length basis between independent parties. However, that presumption may not be valid when related party relationships exist because related parties may enter into transactions which unrelated parties would not enter into.

Also, transactions between related parties may not be effected at the same terms and conditions as between unrelated parties. Sometimes, no price is charged in related party transactions, for example, free provision of management services and the extension of free credit on a debt.

Also, sometimes the operating results and financial position of an enterprise may be affected by a related party relationship even if related party transactions **do not occur.** The mere existence of the relationship may be sufficient to affect the transactions of the reporting enterprise with other parties. For example, a subsidiary may terminate relations with a trading partner on acquisition by the holding company of a fellow subsidiary engaged in the same trade as the former partner. Alternatively, one party may refrain from acting because of the control or significant influence of another - for example, a subsidiary may be instructed by its holding company not to engage in research and development.

Likewise, in certain cases transactions would not have taken place if the related party relationship had not existed. For example, a company that sold a large proportion of its production to its holding company at cost might not have found an alternative customer if the holding company had not purchased the goods.

In view of the aforesaid, the resulting accounting measures may not represent what they usually would be expected to represent. Thus, a related party relationship could have an effect on the financial position and operating results of the reporting enterprise.

4.3 RELATED PARTY RELATIONSHIPS, AS CONTEMPLATED UNDER AS-18

Related Party - As per AS-18, parties are considered to be related if at any time during the reporting period one party has the ability to control the other party or exercise significant influence over the other party in making financial and/or operating decisions.

It is worthwhile to note that AS-18 provides a definitive list of related party relationships to which AS-18 applies. Accordingly, **AS 18 deals only with the following five types of related party relationships described in (a) to (e) below:**

a. Enterprises that directly, or indirectly through one or more intermediaries, control, or are controlled by, or are under common control with, the reporting enterprise (this includes holding companies, subsidiaries and fellow subsidiaries).

> **Note:** This is the case when there is a parent-subsidiary relationship (including relationship among fellow subsidiaries), as illustrated later in this chapter. For meaning of the term control, refer to subsequent discussion under this chapter.

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b. Associates and joint ventures of the reporting enterprise and the investing party or venturer in respect of which the reporting enterprise is an associate or a joint venture.

c. Individuals owning, directly or indirectly, an interest in the voting power of the reporting enterprise that gives them control or significant influence over the enterprise, and relatives of any such individual.

d. Key management personnel and relatives of such personnel; and

e. Enterprises over which any person described in (c) or (d) is able to exercise significant influence. This includes enterprises owned by directors or major shareholders of the reporting enterprise and enterprises that have a member of key management in common with the reporting enterprise.

4.4 WHO ARE NOT DEEMED TO BE RELATED PARTIES UNDER AS-18?

In the context of AS 18, the following are deemed **not to be related parties**:

a. Two companies are not related parties simply because they have a director in common (unless the director is able to affect the policies of both companies in their mutual dealings).

Accordingly, if the common director is able to influence the policies of **both the companies in their mutual dealings –** then related party relationship exists.

b. A single customer, supplier, franchiser, distributor, or general agent with whom an enterprise transacts a significant volume of business merely by virtue of the **resulting economic dependence;** and

c. The parties listed below, in the course of their normal dealings with an enterprise by virtue only of those dealings (although they may circumscribe the freedom of action of the enterprise or participate in its decision-making process):

i. Providers of finance

ii. Trade unions

iii. Public utilities

iv. Government departments and government agencies including government sponsored bodies

4.5 EXEMPTION FROM RELATED PARTY DISCLOSURE IN CERTAIN SITUATIONS

1. **Conflict with the reporting enterprise's duties of confidentiality:** Related party disclosure requirements as laid down in AS 18 do not apply in circumstances where providing such disclosures would conflict with the reporting enterprise's duties of confidentiality as specifically required in terms of a statute or by any regulator or similar competent authority. Put differently, in cases where a statute or a regulator or a similar competent authority governing an enterprise prohibit the enterprise to disclose certain information which is required to be disclosed as per this Standard, disclosure of such information is not warranted. For example, banks are obliged by law to maintain confidentiality in respect of their customers' transactions and this Standard would not override the obligation to preserve the confidentiality of customers' dealings.
2. **Consolidated financial statements:** No disclosure is required in consolidated financial statements in respect of intra-group transactions - since disclosure of transactions between members of a group is unnecessary in consolidated financial statements. This is mainly because consolidated financial statements present information about the holding and its subsidiaries as a single reporting enterprise.
3. **State-controlled enterprises:** No disclosure is required in the financial statements of state-controlled enterprises as regards related party relationships with other state-controlled enterprises and transactions with such enterprises.

4.6 DEFINITIONS OF OTHER TERMS USED IN AS 18

Related party transaction:AS-18 defines related party transaction as, "A transfer of resources or obligations between related parties, regardless of whether or not a price is charged".

Control: As per AS-18 Control means:

a. Ownership, directly or indirectly, 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, or

c. A substantial interest in voting power **and** the power to direct, by statute or agreement, the financial and/or operating policies of the enterprise.

Also, AS-18 clarifies that for the purpose of AS 18, an enterprise is considered to **control the composition** of the board of directors of a company or governing body of an enterprise, if it has the power, without the consent or concurrence of any other person, to appoint or remove all or a majority of directors/members of the governing body of that company/enterprise. Put differently, control to the composition of the Board of directors is determined with reference to the **authority of an enterprise** to appoint or remove all or majority of directors of another enterprise **without concurrence of any other person.**

Further, an enterprise is **deemed** to have the power to appoint a director/ member of the governing body, if any of the following conditions is satisfied:

a. A person cannot be appointed as director/member of the governing body without the exercise in his favour by that enterprise of such a power as aforesaid or

b. A person's appointment as director/member of the governing body follows necessarily from his appointment to a position held by him in that enterprise or

c. The director/member of the governing body is nominated by that enterprise; in case that enterprise is a company, the director is nominated by that company/subsidiary thereof.

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An enterprise is considered to have a **substantial interest** in another enterprise if that enterprise owns, directly or indirectly, 20% or more interest in the **voting power** of the other enterprise. Similarly, an individual is considered to have a substantial interest in an enterprise, if that individual owns, directly or indirectly, **20 per cent or more interest in the voting power** of the enterprise.

Associate: AS-18 defines an Associate as an enterprise in which an investing reporting party has significant influence and which is neither a subsidiary nor a joint venture of that party. Therefore, an associate should not be a subsidiary neither a joint venture of that investing reporting enterprise.

And, the term Significant influence is defined by AS-18 as "Participation in the financial and/or operating policy decisions of an enterprise, but not control of those policies".

Further,AS-18 clarifies that significant influence may be exercised in several ways, for example, (1) by representation on the board of directors;, (2) participation in the policy making process;

(3) material inter-company transactions, (4) interchange of managerial personnel or (5) dependence on technical information.

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

Key Management Personnel: As per AS-18, Key Management Personnel are those persons who have the authority and responsibility for planning, directing and controlling the activities of the reporting enterprise.

For example, in the case of a company, (1) the managing director(s), (2) whole time director(s), (3) manager and (4) any person in accordance with whose directions or instructions the board of directors of the company is accustomed to act, are usually considered key management personnel.

AS-18 further provides an explanation that a non-executive director of a company -is not considered as a key management person under this Standard by virtue of merely his being a director unless he has the authority and responsibility for planning, directing and controlling the activities of the reporting enterprise.

The requirements of AS 18 should not be applied in respect of a non-executive director even if he participates in the financial and/or operating policy decision of the enterprise, unless he falls in any of the categories of 'related party relationships' discussed above.

Relative: As per AS-18, a Relative in relation to an individual, means the spouse, son, daughter, brother, sister, father and mother who may be expected to influence, or be influenced by, that individual in his/her dealings with the reporting enterprise.

Joint Venture - AS-18 defines a Joint Venture as a contractual arrangement whereby two or more parties undertake an economic activity which is subject to joint control.

Joint Control–AS-18 defines a Joint Control as the contractually agreed sharing of power to govern the financial and operating policies of an economic activity so as to obtain benefits from it. Accordingly, when two or more parties contractually agree to share power to govern the financial and operating policies of an economic activity, this contractual agreement is termed as joint control.

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It is pertinent to note that joint venture **does not** depend upon voting power of the parties involved. Rather, it is linked to the **ability to exercise joint control over an economic activity.**

Holding Company–AS-18 defines Holding Company as a company having one or more subsidiaries

Subsidiary AS 18 defines a Subsidiary – as a company:

a. in which another company (the holding company) holds, either by itself and/or through one or more subsidiaries, more than one-half, in nominal value of its equity share capital; or

b. of which another company (the holding company) controls, either by itself and/or through one or more subsidiaries, the composition of its board of directors.

Fellow Subsidiary–AS-18 clarifies that a company is considered to be a fellow subsidiary of another company if both are subsidiaries of the same holding company.

(Refer Illustration 8)

4.7 DISCLOSURE REQUIREMENTS UNDER AS-18

At the outset, it is to be noted that AS-18 prescribe related party disclosure requirements.

a. name of the related party and

b. nature of the related party relationship **where control exists** should be disclosed - irrespective of whether or not there have been transactions between the related parties.

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

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

i. The name of the transacting related party;

ii. A description of the relationship between the parties;

iii. A description of the nature of transactions;

iv. Volume of the transactions either as an amount or as an appropriate proportion;

v. Any other elements of the related party transactions necessary for an understanding of the financial statements;

vi. The amounts or appropriate proportions of outstanding items pertaining to related parties at the balance sheet date and provisions for doubtful debts due from such parties at that date;

vii. Amounts written off or written back in the period in respect of debts due from or to related parties.

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Items of a similar nature may be disclosed in aggregate by type of related party except when separate disclosure is necessary for an understanding of the effects of related party transactions on the financial statements of the reporting enterprise.

Remuneration paid to key management personnel should be considered as a related party transaction requiring disclosures. In case non-executive directors on the Board of Directors are not related parties, remuneration paid to them should not be considered a related party transaction.

4.8 LIST OF RELATED PARTY TRANSACTIONS, TO BE DISCLOSED (WHAT NEEDS TO BE DISCLOSED?)

AS-18 gives following **examples** of related party transactions, in respect of which disclosures may be made by a reporting enterprise:

1. Purchases or sales of goods (finished or unfinished)
2. Purchases or sales of fixed assets
3. Rendering or receiving of services
4. Agency arrangements
5. Leasing or hire purchase arrangements
6. Transfer of research and development
7. Licence agreements
8. Finance (including loans and equity contributions in cash or in kind)
9. Guarantees and collaterals
10. Management controls including for deputation of employees.

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ILLUSTRATIONS

Illustration 1

Identify the related parties in the following case as per AS 18:

A Ltd. holds 51% of

B Ltd. B Ltd holds 51% of O Ltd.

Z Ltd holds 49% of O Ltd.

Solution

In relation to Reporting enterprise - A Ltd.

- B Ltd. (subsidiary) is a related party
- O Ltd. (subsidiary) is a related party In relation to Reporting enterprise - B Ltd.
- A Ltd. (holding company) is a related party
- O Ltd. (subsidiary) is a related party In relation to Reporting enterprise - O Ltd.
- A Ltd. (ultimate holding company) is a related party
- B Ltd. (holding company) is a related party
- Z Ltd. (investor/ investing party) is a related party (O Ltd being Associate of Z Ltd)
  Reporting enterprise - Z Ltd.
- O Ltd. (Associate) is a related party

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Illustration 2

Consider a scenario wherein:

- **A Ltd. has 60% voting right in B Ltd.**
- **A Ltd. also has 22% voting right in C Ltd.; and**
- **B Ltd. has 30% voting right in C Ltd.**

Whether C Ltd. is to be treated under AS-18 as a party related to A Ltd.?

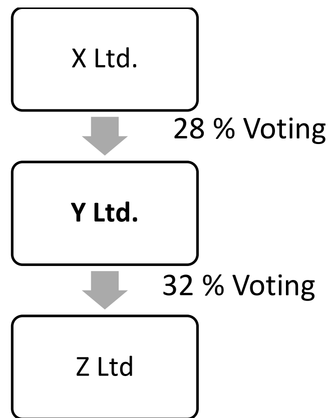
Solution

Yes – in relation to A Ltd. (the reporting enterprise), C Ltd. is a related party under AS-18. This is because A Ltd. indirectly controls C Ltd. In this case, A Ltd. (together with its subsidiary B Ltd.) controls more than one half of the voting rights of C Ltd.

Illustration 3

Consider a scenario wherein:

- **X Ltd. holds 28% voting right in Y Ltd. (and hence Y Ltd. is an associate of X Ltd.)**
- **Y Ltd. holds 32% voting right in Z Ltd. (and hence Z Ltd. is an associate of Y Ltd.)**



In the above case, since Y Ltd. is an associate of X Ltd. – Y Ltd. is a related party to X Ltd.

Likewise, since Z Ltd. is an associate of Y Ltd. - Z Ltd. is a related party to Y Ltd.

The question is: Whether Z Ltd. is to be treated under AS-18 as a party related to X Ltd.?

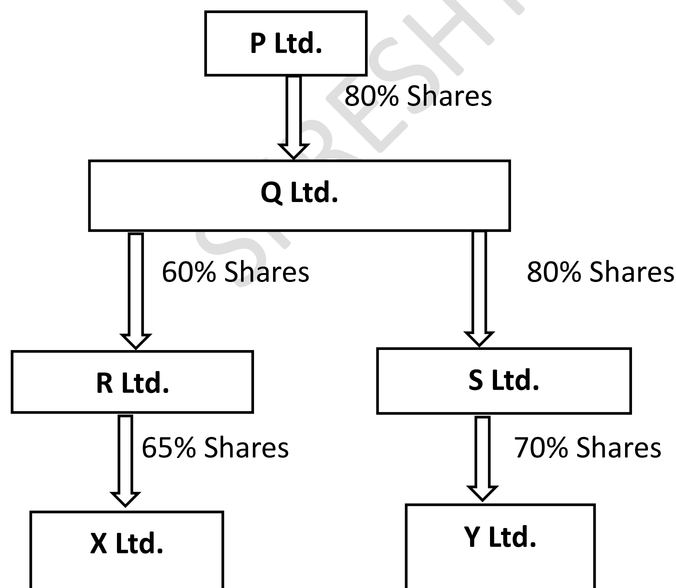
Solution

No – in relation to X Ltd. (the reporting enterprise), Z Ltd. is a not a related party.

This is because as per the requirements of AS-18, 'associate of an associate' is not a related party.

Illustration 4

Consider the following organization structure related to P Ltd.



Given the above structure: Identify related party relationships, if R Ltd. is the reporting enterprise

Solution

The following table identifies the related party relationships for R Ltd. (being the reporting enterprise):

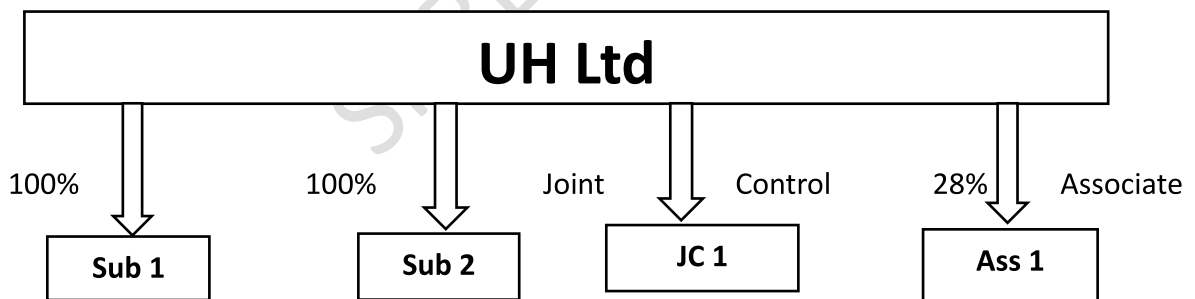
Party Name	Relationship under AS-18
P Ltd.	• P Ltd. has indirect control on R Ltd. (through Q Ltd.)

	♦ Hence R Ltd. is related to P Ltd.
Q Ltd.	♦ Q Ltd. has direct control of R Ltd. ♦ Hence R Ltd. is related to Q Ltd.
S Ltd.	♦ R Ltd. and S Ltd. are under common control of Q Ltd. ♦ Hence R Ltd. is related to S Ltd.
X Ltd.	♦ X Ltd. is controlled by R Ltd. ♦ Hence R Ltd. is related to X Ltd.
Y Ltd.	♦ Y Ltd. is the sub-subsidiary of Q Ltd. ♦ Both R Ltd. and Y Ltd. are under common control of Q Ltd. ♦ Hence R Ltd. is related to Y Ltd.

Illustration 5

Consider the following organization structure related to UH Ltd. (the ultimate parent company of a Group), wherein UH Ltd. has made the following investments:

- **Investment in two of the wholly owned subsidiaries, viz. Sub 1 and Sub 2**
- **Investment in JC 1, in which UH Ltd. has a joint control**
- **20% investment in Ass 1 (and hence, Ass 1 is an associate of UH Ltd.)**



Given the above structure: Identify related party relationships for each of the above entities under AS-18

Solution

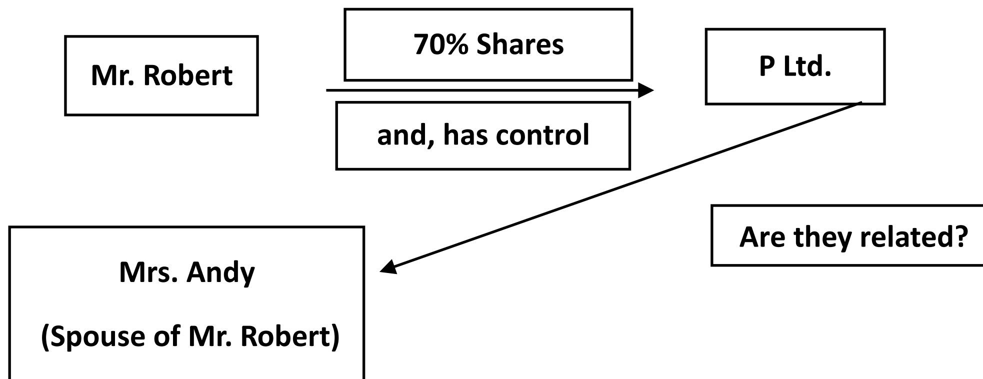
The following table identifies the related party relationships for each of the entities in the Group:

Reporting enterprise	Related Party as per AS-18
UH Ltd.	All the four entities (viz. Sub 1, Sub 2, JC 1 and Ass 1)
Sub 1	Only two of the entities in the Group (viz. UH Ltd. and Sub 2)
Sub 2	Only two of the entities in the Group (viz. UH Ltd. and Sub 1)
JC 1	Only UH Ltd.
Ass 1	Only UH Ltd.

Illustration 6

Consider a scenario wherein:

- **Mr. Robert holds 70% shares and voting rights in P Ltd**



Determine: Whether Andy (spouse of Mr. Robert) is a related party to P Ltd. under AS-18?

Solution

Yes – Andy is a related party to P Ltd., in view of the requirements of AS-18.

It may be recalled that under AS-18 'relatives of individuals owning an interest in the voting power of the reporting enterprise that gives them control or significant influence over the enterprise' are considered as related parties.

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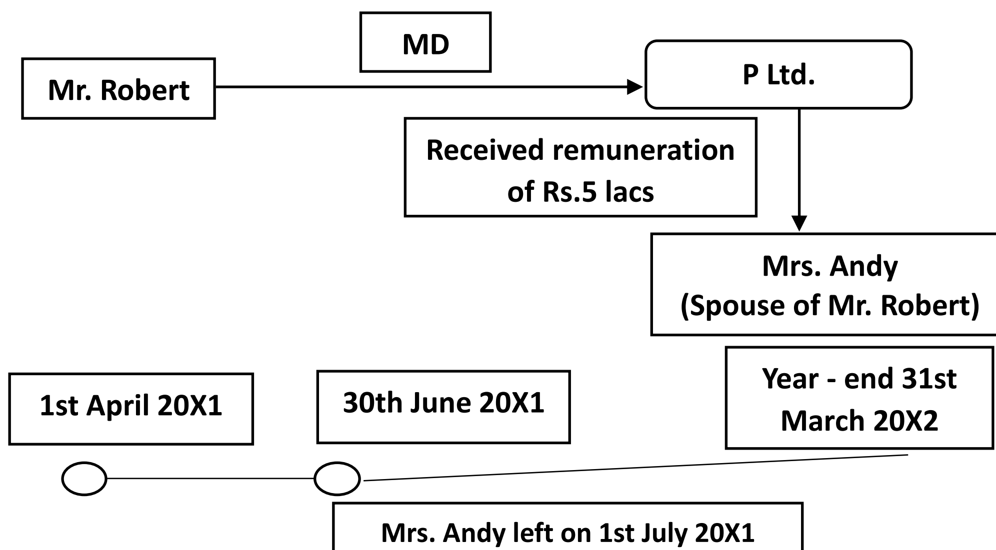
Illustration 7

Consider a scenario wherein:

- **Mr. Robert is a Managing Director of P Ltd.**
- **Andy (spouse of Robert) received a remuneration of Rs 5 lacs from P Ltd. – for the services she rendered to P Ltd. for the period 1st April 20X1 through 30th June 20X1**
- **Andy left the services of P Ltd. on 1st July 20X1**
- **Consider 31st March 20X2 as the year-end date for P Ltd.**



Whether Andy is to be identified as related party at the year-end date (31st March 20X2) for the purposes of AS-18?

Solution

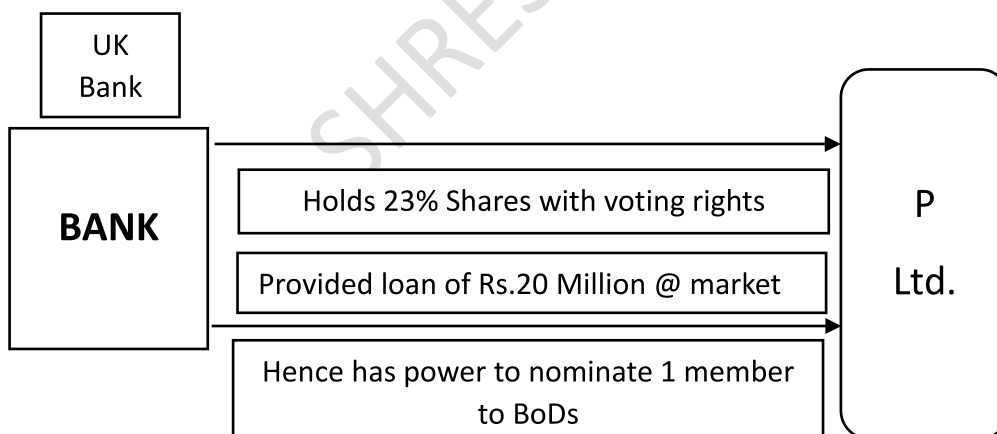
Yes – This is because as per AS-18, parties are considered to be related if at any time during the reporting period one party has the ability to control the other party or exercise significant influence over the other party in making financial and/or operating decisions.

Hence Andy (being the spouse and relative of the KMP of P Ltd.) **needs to be reported** as related party at the year-end date (i.e. 31st March 20X2). This is because the remuneration Andy received from P Ltd. (for the period April 20X1 to 30 June 20X1) falls within the reporting year April 20X1 to March 20X2.

Illustration 8

Consider a scenario wherein:

- **UK Bank holds 23% equity shares with voting rights in P Ltd.**
- **The bank has provided a loan of Rs. 20 million to P Ltd. at market interest rate**
- **As per the terms and conditions of the loan agreement, the bank has appointed one person as its nominee to the board of directors of P Ltd. and any major transaction to be entered into by P Ltd. will require the consent of the Bank**



Determine: Whether under AS-18 - UK Bank is a related party to P Ltd. (the reporting enterprise)?

Solution

In the instant case, the UK Bank holds 23% shares with voting rights in P Ltd. and hence is deemed to exercise significant influence over P Ltd.

The bank is also a provider of finance to P Ltd. (the reporting enterprise) and as per AS-18, parties like providers of finance are deemed **not to be considered** as a related party in the course of normal dealings with an enterprise by virtue **only of those dealings.** However, this exemption will not be available to UK Bank in this case – since it exercises significant influence over P Ltd. (by virtue of holding 23% shares with voting rights in P Ltd.)

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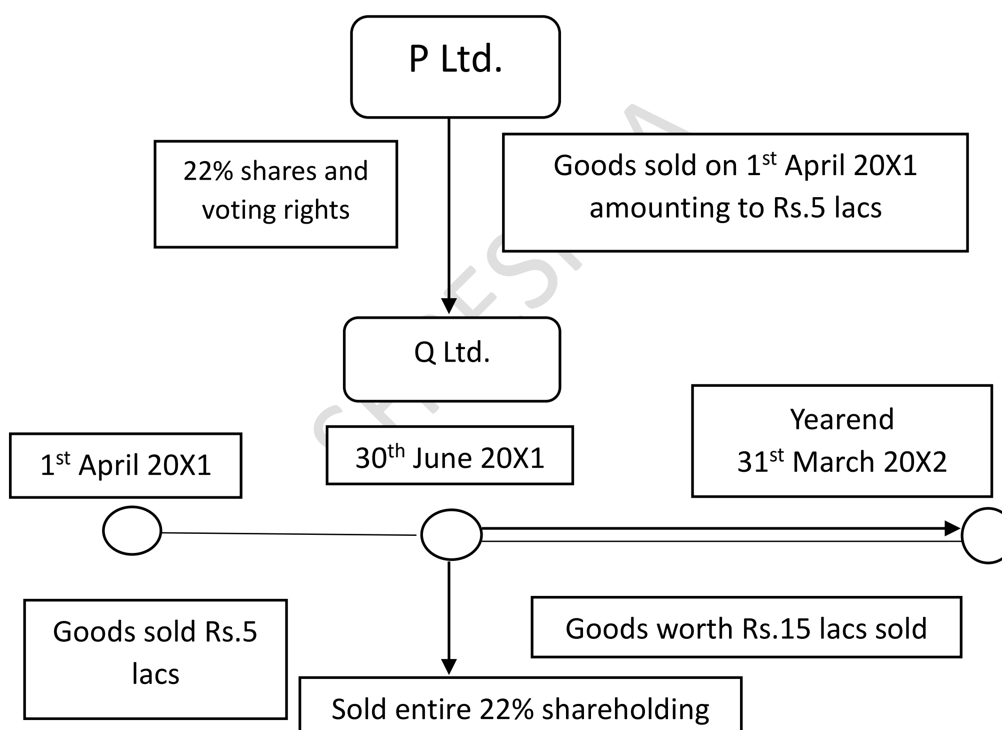
Accordingly, for P Ltd. (the reporting enterprise), the UK Bank is a related party and it will be required to disclose the transactions with UK Bank in its financial statements.

Illustration 9

Consider a scenario wherein:

- **P Ltd. hold 22% shares and voting rights in Q Ltd. (and hence Q Ltd. is an associate of P Ltd.)**
- **On 1st April 20X1, P Ltd. sold certain goods to Q Ltd. amounting to Rs. 5 lacs**
- **On 30th June 20X1, P Ltd. sold its entire 22% stake in Q Ltd. (and hence the related party relationship ceased to exist after 30th June 20X1)**
- **However, P Ltd. continued supply goods to Q Ltd. subsequent to 30th June 20X1 (just like any other customer) and sold goods worth Rs. 15 lacs during 9-month period ended 31st March 20X2**
- **Consider 31st March 20X2 as the year-end date for P Ltd.**



Determine whether the transaction for the entire year (ending on 31st March 20X2) is required to be disclosed under AS-18 as related party transaction.

Solution

No – This is because as per AS-18, the disclosure requirements under the Standard relate only to the period **during related party relationship existed.**

Accordingly, only transactions between P Ltd and Q Ltd till 30th June 20X1 (being sale of goods worth Rs.5 lacs) are required to be reported / disclosed under AS-18.

Transactions entered into after 30th June 20X1 are **NOT required** to be disclosed under AS-18.

Illustration 10

Narmada Ltd. sold goods for Rs.90 lakhs to Ganga Ltd. during financial year ended 31-3-20X1. The Managing Director of Narmada Ltd. owns 100% shares of Ganga Ltd. The sales were made to Ganga Ltd. at normal selling prices by Narmada Ltd. The Chief accountant of Narmada Ltd contends that these sales need not require a different treatment from the other sales made by the company and hence no disclosure is necessary as per the accounting standard. Is the Chief Accountant correct?

Solution

As per AS 18 'Related Party Disclosures', Enterprises over which a key management personnel is able to exercise significant influence are related parties. This includes enterprises owned by directors or major shareholders of the reporting enterprise and enterprise that have a member of key management in common with the reporting enterprise.

In the given case, Narmada Ltd. and Ganga Ltd are related parties and hence disclosure of transaction between them **is required** irrespective of whether the transaction was done at normal selling price.

Hence the contention of Chief Accountant of Narmada Ltd is **wrong.**

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TEST YOUR KNOWLEDGE

MCQs

1. **According to AS-18 Related Party Disclosures, which ONE of the following is not a related party of Skyline Limited?**
    a. **A shareholder of Skyline Limited owning 30% of the ordinary share capital**
    b. **An entity providing banking facilities to Skyline Limited in the normal course of business**
    c. **An associate of Skyline Limited**
    d. **Key management personnel of Skyline Limited**

2. **Are the following statements in relation to related parties true or false, according to AS-18 Related Party Disclosures?**
    A. **A party is related to another entity that it is jointly controlled by.**
    B. **A party is related to another entity that it controls.**

Statement (A)	Statement (B)
a. False	False
b. False	True
c. True	False
d. True	True

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3. **Which of the following is not a related party as envisaged by AS-18 Related Party Disclosures?**
    a. **A director of the entity**
    b. **The parent company of the entity**
    c. **A shareholder of the entity that holds 1% stake in the entity**
    d. **The spouse of the managing director of the entity**

4. **According to AS-18 Related Party Disclosures, related party transaction is a transfer of resources or obligations between related parties – provided a price is charged for such transfer.**
    a. **True**
    b. **False**

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

ANSWERS/HINTS

MCQs

1.	**b.**	An entity providing banking facilities to Skyline Limited in the normal course of business
2.	**d.**	True
3.	**c.**	A shareholder of the entity that holds 1% stake in the entity
4.	**b.**	False
5.	**b.**	False

THEORETICAL QUESTIONS

Q.NO.1. Who are related parties under AS 18? What are the related party disclosure requirements?

ANSWER

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

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

i. The name of the transacting related party;

ii. A description of the relationship between the parties;

iii. A description of the nature of transactions;

iv. Volume of the transactions either as an amount or as an appropriate proportion;

v. Any other elements of the related party transactions necessary for an understanding of the financial statements;

vi. The amounts or appropriate proportions of outstanding items pertaining to related parties at the balance sheet date and provisions for doubtful debts due from such parties at that date;

vii. Amounts written off or written back in the period in respect of debts due from or to related parties.

Q.NO.2. ABC Limited is in the business of manufacturing textiles. It has certain commercial contracts with its customers and those customer contracts carry various clauses, imposing restriction on ABC Limited for disclosure of certain information. Accordingly, the company doesn't intend to provide related party disclosure under AS-18 in its ensuing financial statements. Is this correct?

ANSWER

As per AS-18 stipulate that related party disclosure requirements under AS-18 **do not apply** in circumstances, where providing such disclosures would conflict with the reporting enterprise's duties of confidentiality, as specifically required in terms of a statute or by any regulator or similar competent authority.

In case, where (1) a statute or (2) a regulator or (3) a similar competent authority governing an enterprise prohibit the enterprise to disclose certain information, which is required to be disclosed as per AS 18, disclosure of such information is **not warranted**. For example, banks are obliged by law to maintain confidentiality in respect of their customers' transactions and AS-18 would not override the obligation to preserve the confidentiality of customers' dealings.

However, this exemption is **not available** in respect of confidentiality provisions in a commercial contract between two enterprises - where confidentiality is not specifically required in terms of (1) a statute or (2) by any regulator or (3) similar competent authority.

Therefore, in the given case AS-18 related party disclosures would have to be made by ABC Limited in its ensuing financial statements.

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Q.NO.3. Should the related parties be identified as at the reporting date (i.e. balance sheet date) for the purposes of AS-18? In disclosing transactions with related parties, are the transactions of the entire reporting period to be disclosed or only those for the period during which related party relationship exists?

ANSWER

As per the definition of related parties in AS-18, the existence of a related party relationship should be identified at all points during the year (and not only at the close of the financial year). However, AS 18 requires disclosure of transactions with these parties only during the existence of the related party relationship.

PRACTICAL QUESTIONS

Q.NO.1. Mr. Raj, a relative of key management personnel, received remuneration of Rs.2,50,000 for his services in the company for the period from 1.4.20X1 to 30.6.20X1. On 1.7.20X1, he left the service of the company.

Should the relative be identified as at the closing date i.e. on 31.3.20X2 for the purposes of AS 18?

SOLUTION

According to AS 18 on 'Related Party Disclosures', parties are considered to be related if at any time during the reporting period one party has the ability to control the other party or exercise significant influence over the other party in making financial and/or operating decisions. Hence Mr. Raj, a relative of key management personnel, should be identified as related party for disclosure in the financial statements for the year ended 31.3.20X2.

Q.NO.2. X Ltd. sold goods to its associate company during the 1st quarter ended 30.6.20X1. After that, the related party relationship ceased to exist. However, goods were supplied as were supplied to any other ordinary customer. Decide whether transactions of the entire year have to be disclosed as related party transaction.

SOLUTION

As per AS 18, transactions of X Ltd. with its associate company for the first quarter ending 30.06.20X1 only are required to be disclosed as related party transactions. The transactions for the period in which related party relationship did not exist would not be reported.

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Q.NO.3. You are required to identify the related parties in the following cases as per AS 18:

M Ltd. holds 61 % shares of S Ltd.

S Ltd. holds 51 % shares of F Ltd.

C Ltd. holds 49% shares of F Ltd.

(Give your answer - Reporting Entity wise for M Ltd., S Ltd., C Ltd. and F Ltd.)

SOLUTION

Reporting Entity	Related Party
M Ltd.	S Ltd. (subsidiary) F Ltd.(subsidiary)
S Ltd.	M Ltd. (holding company) F Ltd. (subsidiary)
F Ltd.	M Ltd. (ultimate holding company) S Ltd. (holding company) C Ltd. (investor/ investing party)
C Ltd.	F Ltd. (associate)

UNIT 5: ACCOUNTING STANDARD 20: EARNINGS PER SHARE

LEARNING OUTCOMES

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

- Basic Earnings Per Share
  - Issues related to Numerator – Earnings
  - Issues related to Denominator – Weighted average number of shares
- Diluted Earnings Per Share
  - Issues related to Numerator – Earnings
  - Issues related to Denominator – Weighted average number of shares
- Dilutive Potential Equity Shares
- Restatement of Earnings per share
- Disclosures

5.1 INTRODUCTION

The objective of AS 20 is to describe principles for determination (i.e. computation) and presentation (i.e. presentation in the Statement of Profit and Loss) of earnings per share which will improve comparison of performance among different enterprises for the same period and among different accounting periods for the same enterprise.

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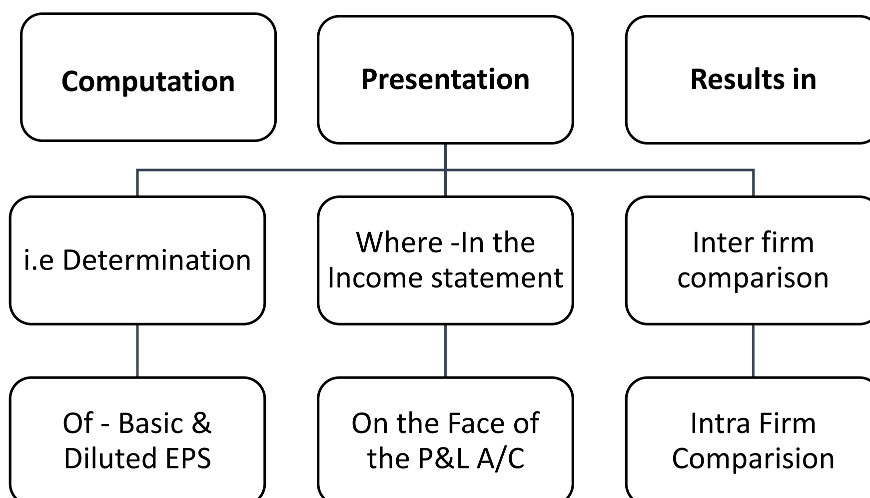

Earnings per share (EPS) is a financial ratio indicating the amount of profit or loss for the period attributable to each equity share and AS 20 gives computational methodology for determination and presentation of basic and diluted earnings per share.

This Accounting Standard is mandatory for all companies. However, disclosure of diluted earnings per share (both including and excluding extraordinary items) is not mandatory for SMCs. Such companies are however encouraged to make these disclosures.

In consolidated financial statements, the information required by AS 20 should be presented on the basis of consolidated information.

5.2 DEFINITION OF THE TERMS USED IN AS 20

An equity share is a share other than a preference share.

A preference share is a share carrying preferential rights to dividends and repayment of capital.

A financial instrument is any contract that gives rise to both a financial asset of one enterprise and a financial liability or equity shares of another enterprise.

A financial asset is any asset that is

a. Cash;

b. A contractual right to receive cash or another financial asset from another enterprise;

c. A contractual right to exchange financial instruments with another enterprise under conditions that are potentially favourable; or

d. An equity share of another enterprise.

A financial liability is any liability that is a contractual obligation to deliver cash or another financial asset to another enterprise or to exchange financial instruments with another enterprise under conditions that are potentially unfavourable.

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A potential equity share is a financial instrument or other contract that entitles, or may entitle, its holder to equity shares.

Examples of potential equity shares are:

a. Debt instruments or preference shares, that are convertible into equity shares;

b. Share warrants;

c. Options including employee stock option plans under which employees of an enterprise are entitled to receive equity shares as part of their remuneration and other similar plans; and

d. Shares which would be issued upon the satisfaction of certain conditions resulting from contractual arrangements (contingently issuable shares), such as the acquisition of a business or other assets, or shares issuable under a loan contract upon default of payment of principal or interest, if the contract so provides.

Note:

A partly paid-up share where the holder is not entitled to dividends is treated as a potential equity share for the purposes of computing Diluted EPS.

Share warrants or options are financial instruments that give the holder the right to acquire equity shares.

Fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.

Basic Earnings Per Share

Basic earnings per share is calculated as

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

5.3 EARNINGS-BASIC

All items of income and expense which are recognised in a period, including tax expense and extraordinary items, are included in the determination of the net profit or loss for the period unless AS 5 requires or permits otherwise.

The amount of preference dividends and any attributable tax thereto for the period is deducted from the net profit for the period (or added to the net loss for the period) in order to calculate the net profit or loss for the period attributable to equity shareholders.

The amount of preference dividends for the period that is deducted from the net profit for the period is:

a. The amount of any preference dividends on non-cumulative preference shares provided for in respect of the period; and

b. The full amount of the required preference dividends for cumulative preference shares for the period, whether or not the dividends have been provided for. The amount of preference dividends for the period does not include the amount of any preference dividends for cumulative preference shares paid or declared during the current period in respect of previous periods.

Note:

If an enterprise has more than one class of equity shares, net profit or loss for the period is apportioned over the different classes of shares in accordance with their dividend rights.

[In other words, there will be more than 1 Basic EPS for such a company; i.e. EPS for each class of equity shares]

A quick recap of adjustments to be made to the numerator will be as under:

Particulars	Adjusted in the numerator of Basic EPS
Tax expense (Current and Deferred Tax)	Yes
Exceptional items as per AS 5	Yes
Extraordinary items as per AS 5	Yes

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Changes in Accounting estimates as per AS 5	Yes
Changes in Accounting Policy as per AS 5	Yes
Amount of preference dividends and any attributable tax thereto **a.** Non-cumulative preference **b.** Cumulative preference shares	 **Yes – only if** it has been provided in the books Yes – irrespective, whether or not the dividends have been provided for in the books

5.4 PER SHARE- BASIC

The number of shares used in the denominator for basic EPS should be the weighted average number of equity shares outstanding during the period.

The weighted average number of equity shares outstanding during the period is the number of shares outstanding at the beginning of the period, adjusted by the number of equity shares bought back or issued during the period multiplied by a time-weighting factor.

The time-weighting factor is:

$$\frac{\text{Numbers of days the shares are outstanding}}{\text{Number of days in the period}}$$

Although the Standard defines the time-weighting factor as being determined on a daily basis, it acknowledges that a reasonable approximation of the weighted average is adequate in many circumstances.

(Refer Illustration 1)

5.5 SHARES ISSUED IN A SCHEME OF AMALGAMATION

1. Equity shares issued as part of the consideration in an **amalgamation in the nature of purchase** are included in the weighted average number of shares as of the **date of the acquisition** because the transferee incorporates the results of the operations of the transferor into its statement of profit and loss as from the date of acquisition.
2. Equity shares issued as part of the consideration in an **amalgamation in the nature of merger** are included in the calculation of the weighted average number of shares **from the beginning** of the reporting period because the financial statements of the combined enterprise for the reporting period are prepared as if the combined entity had existed from the beginning of the reporting period. Therefore, the number of equity shares used for the calculation of basic

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earnings per share in an amalgamation in the nature of merger is the aggregate of the weighted average number of shares of the combined enterprises, adjusted to equivalent shares of the enterprise whose shares are outstanding after the amalgamation.

Partly paid equity shares are treated as a fraction of an equity share to the extent that they were entitled to participate in dividends relative to a fully paid equity share during the reporting period.

(Refer Illustration 2)

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

Contingently Issuable Shares

Equity shares which are issuable upon the satisfaction of certain conditions resulting from contractual arrangements (contingently issuable shares) are considered outstanding, and included in the computation of basic earnings per share from the date when all necessary conditions under the contract have been satisfied.

Bonus Issue, Share split and Right issue

Equity shares may be issued, or the number of shares outstanding may be reduced, without a corresponding change in resources. Examples include:

a. A bonus issue;

b. A bonus element in any other issue, for example a bonus element in a rights issue to existing shareholders;

c. A share split; and

d. A reverse share split (consolidation of shares).

In case of a bonus issue or a share split, equity shares are issued to existing shareholders for no additional consideration. Therefore, the number of equity shares outstanding is increased without an increase in resources. The number of equity shares outstanding before the event is adjusted for the proportionate change in the number of equity shares outstanding as if the event had occurred at the beginning of the earliest period reported means along with the impact to current year adjustment, it will also impact the calculation of EPS of last year retrospectively.

For example, upon a two-for-one bonus issue, the number of shares outstanding prior to the issue is multiplied by a factor of three to obtain the new total number of shares, or by a factor of two to obtain the number of additional shares.

(Refer Illustration 3)

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The issue of equity shares at the time of exercise or conversion of potential equity shares will not usually give rise to a bonus element, since the potential equity shares will usually have been issued for full value, resulting in a proportionate change in the resources available to the enterprise. In a **rights issue,** on the other hand, the exercise price is often less than the fair value of the shares. Therefore, a rights issue usually includes a bonus element. [Thus, it may be noted that if a company makes a right issue at fair value itself, then there will be no bonus element in the right issue]. The number of equity shares to be used in calculating basic earnings per share for all periods prior to the rights issue is the number of equity shares outstanding prior to the issue, multiplied by the following adjustment factor:

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

The theoretical ex-rights fair value per share is calculated by adding the aggregate fair value of the shares immediately prior to the exercise of the rights to the proceeds from the exercise of the rights, and dividing by the number of shares outstanding after the exercise of the rights.

(Refer Illustration 4)

5.6 DILUTED EARNINGS PER SHARE

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

a. The net profit for the period attributable to equity shares is:

- **i.** Increased by the amount of dividends recognised in the period in respect of the dilutive potential equity shares as adjusted for any attributable change in tax expense for the period;
- **ii.** Increased by the amount of interest recognised in the period in respect of the dilutive potential equity shares as adjusted for any attributable change in tax expense for the period; and
- **iii.** Adjusted for the after-tax amount of any other changes in expenses or income that would result from the conversion of the dilutive potential equity shares.

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

For the purpose of AS 20, share application money pending allotment or any advance share application money as at the balance sheet date, which is not statutorily required to be kept separately and is being utilised in the business of the enterprise, is treated in the same manner as dilutive potential equity shares for the purpose of calculation of diluted earnings per share.

SHRESHTA

Note: As mentioned earlier, a partly paid-up share where the holder is not entitled to dividends is treated as a potential equity share for the purposes of computing Diluted EPS.

5.7 EARNINGS-DILUTED

For the purpose of calculating diluted earnings per share, the amount of net profit or loss for the period attributable to equity shareholders, should be adjusted by the following, after taking into account any attributable change in tax expense for the period:

a. any dividends on dilutive potential equity shares which have been deducted in arriving at the net profit attributable to equity shareholders;

b. interest recognised in the period for the dilutive potential equity shares; and

c. any other changes in expenses or income that would result from the conversion of the dilutive potential equity shares.

After the potential equity shares are converted into equity shares, the dividends, interest and other expenses or income associated with those potential equity shares will no longer be incurred (or earned). Instead, the new equity shares will be entitled to participate in the net profit attributable to equity shareholders. Therefore, the net profit for the period attributable to equity shareholders calculated in Basic Earnings Per Share is increased by the amount of dividends, interest and other expenses that will be saved, and reduced by the amount of income that will cease to accrue, on the conversion of the dilutive potential equity shares into equity shares. The amounts of dividends, interest and other expenses or income are adjusted for any attributable taxes.

(Refer Illustration 5)

5.8 PER SHARE- DILUTED

For the purpose of calculating diluted earnings per share, the number of equity shares should be the aggregate of the weighted average number of equity shares, and the weighted average number of equity shares which would be issued on the conversion of all the dilutive potential equity shares into equity shares. Dilutive potential equity shares should be deemed to have been converted into equity shares at the beginning of the period or, if issued later, the date of the issue of the potential equity shares.

The number of equity shares which would be issued on the conversion of dilutive potential equity shares is determined from the terms of the potential equity shares. The computation assumes the most advantageous conversion rate or exercise price from the standpoint of the holder of the potential equity shares.

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Equity shares which are issuable upon the satisfaction of certain conditions resulting from contractual arrangements (contingently issuable shares) are considered outstanding and included in the computation of both the basic earnings per share and diluted earnings per share from the date when the conditions under a contract are met. If the conditions have not been met, for computing the diluted earnings per share, contingently issuable shares are included as of the beginning of the period (or as of the date of the contingent share agreement, if later). The number of contingently issuable shares included in this case in computing the diluted earnings per share is based on the number of shares that would be issuable if the end of the reporting period was the end of the contingency period. Restatement is not permitted if the conditions are not met when the contingency period actually expires subsequent to the end of the reporting period. The provisions of this paragraph apply equally to potential equity shares that are issuable upon the satisfaction of certain conditions (contingently issuable potential equity shares).

Potential equity shares are weighted for the period they were outstanding. Potential equity shares that were cancelled or allowed to lapse during the reporting period are included in the computation of diluted earnings per share only for the portion of the period during which they were outstanding. Potential equity shares that have been converted into equity shares during the reporting period are included in the calculation of diluted earnings per share from the beginning of the period to the date of conversion; from the date of conversion, the resulting equity shares are included in computing both basic and diluted earnings per share.

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A quick recap of the timing factor when these potential equity shares will be considered as a part of the denominator for weighted average computations.

Particulars	From which date	Till which date
Potential equity shares which were issued last year and not yet converted into equity shares in current year	Beginning of the year	End of the year
Potential equity shares which were issued last year and have been converted into equity shares in current year	Beginning of the year	End of the year (Till date of conversion as a potential equity share and after conversion both as a part of Basic and Diluted EPS)
Potential equity shares which were issued in the current year and not yet converted into equity shares in current year	Date of issue	End of the year

Potential equity shares which were issued last year and have been cancelled or have lapsed in current year	Beginning of the year	Till the date of cancellation or when they lapse

Diluted EPS in case of share options

For the purpose of calculating diluted earnings per share, an enterprise should assume the exercise of dilutive options and other dilutive potential equity shares of the enterprise. The assumed proceeds from these issues should be considered to have been received from the issue of shares at fair value. The difference between the number of shares issuable and the number of shares that would have been issued at fair value should be treated as an issue of equity shares for no consideration.

Options and other share purchase arrangements are dilutive when they would result in the issue of equity shares for less than fair value. The amount of the dilution is fair value less the issue price. Therefore, in order to calculate diluted earnings per share, each such arrangement is treated as consisting of:

a. A contract to issue a certain number of equity shares at their average fair value during the period. The shares to be so issued are fairly priced and are assumed to be neither dilutive nor anti-dilutive. They are ignored in the computation of diluted earnings per share; and

b. A contract to issue the remaining equity shares for no consideration. Such equity shares generate no proceeds and have no effect on the net profit attributable to equity shares outstanding. Therefore, such shares are dilutive and are added to the number of equity shares outstanding in the computation of diluted earnings per share.

(Refer Illustration 6)

Note: The earnings have not been increased as the total number of shares has been increased only by the number of shares (25,000) deemed for the purpose of the computation to have been issued for no consideration.

5.9 DILUTIVE POTENTIAL EQUITY SHARES

Potential equity shares are anti-dilutive when their conversion to equity shares would increase earnings per share from continuing ordinary activities or decrease loss per share from continuing ordinary activities. The effects of anti-dilutive potential equity shares are ignored in calculating diluted earnings per share.

Thus, it is important to note that the 'control factor' is the profit from **continuing ordinary activities.**

In simple words, we can conclude as under:

SHRESHTA

Particulars	Remarks	Is it to be taken as a part of Diluted EPS or not?
Conversion to equity shares would **decrease earnings** per share from continuing ordinary activities.	Dilutive	Yes
Conversion to equity shares would **increase earnings** per share from continuing ordinary activities.	Anti-dilutive	No
Conversion to equity shares would **increase loss** per share from continuing ordinary activities.	Dilutive	Yes
Conversion to equity shares would **decrease loss** per share from continuing ordinary activities.	Anti-dilutive	No

(Refer Illustration 7)

In case there are more than 1 potential equity shares:

In considering whether potential equity shares are dilutive or anti-dilutive, each issue or series of potential equity shares is considered separately rather than in aggregate. The sequence in which potential equity shares are considered may affect whether or not they are dilutive. Therefore, in order to maximise the dilution of basic earnings per share, each issue or series of potential equity shares is considered in sequence from the most dilutive to the least dilutive. For the purpose of determining the sequence from most dilutive to least dilutive potential equity shares, the earnings per incremental potential equity share is calculated. Where the earnings per incremental share is the least, the potential equity share is considered most dilutive and vice-versa.

SHRESHTA

5.10 RESTATEMENT

If the number of equity or potential equity shares outstanding increases as a result of a bonus issue or share split or decreases as a result of a reverse share split (consolidation of shares), the calculation of basic and diluted earnings per share should be adjusted for all the periods presented. If these changes occur after the balance sheet date but before the date on which the financial statements are approved by the board of directors, the per share calculations for those financial statements and any prior period financial statements presented should be based on the new number of shares. When per share calculations reflect such changes in the number of shares, that fact should be disclosed.

5.11 PRESENTATION

An enterprise should present basic and diluted earnings per share on the face of the statement of profit and loss for each class of equity shares that has a different right to share in the net profit for the period. An enterprise should present basic and diluted earnings per share with equal prominence for all periods presented.

AS 20 requires an enterprise to present basic and diluted earnings per share, even if the amounts disclosed are negative (a loss per share).

5.12 DISCLOSURE

An enterprise should disclose the following:

a. Where the statement of profit and loss includes extraordinary items (as defined is AS 5), basic and diluted EPS computed on the basis of earnings excluding extraordinary items (net of tax expense);

b. The amounts used as the numerators in calculating basic and diluted earnings per share, and a reconciliation of those amounts to the net profit or loss for the period;

c. The weighted average number of equity shares used as the denominator in calculating basic and diluted earnings per share, and a reconciliation of these denominators to each other; and

d. The nominal value of shares along with the earnings per share figures.

If an enterprise discloses, in addition to basic and diluted earnings per share, per share amounts using a reported component of net profit other than net profit or loss for the period attributable to equity shareholders, such amounts should be calculated using the weighted average number of equity shares determined in accordance with AS 20. If a component of net profit is used which is not reported as a line item in the statement of profit and loss, a reconciliation should be provided between the component used and a line item which is reported in the statement of profit and loss. Basic and diluted per share amounts should be disclosed with equal prominence.

SHRESHTA

ILLUSTRATIONS

Illustration 1

Date	Particulars			Balance
1st January	**Balance at beginning of year**	**1,800**	**-**	**1,800**
31st May	**Issue of shares for cash**	**600**	**-**	**2,400**
1st November	**Buy Back of shares**	**-**	**300**	**2,100**

Calculate Weighted Number of Shares.

Solution

Computation of Weighted Average:

(1,800 x 5/12) + (2,400 x 5/12) + (2,100 x 2/12) = 2,100 shares.

The weighted average number of shares can alternatively be computed as follows:

(1,800 x12/12) + (600 x 7/12) - (300 x 2/12) = 2,100 shares

In most cases, shares are included in the weighted average number of shares from the date the consideration is receivable, for example:

a. Equity shares issued in exchange for cash are included when cash is receivable;

b. Equity shares issued as a result of the conversion of a debt instrument to equity shares are included as of the date of conversion;

c. Equity shares issued in lieu of interest or principal on other financial instruments are included as of the date interest ceases to accrue;

d. Equity shares issued in exchange for the settlement of a liability of the enterprise are included as of the date the settlement becomes effective;

e. Equity shares issued as consideration for the acquisition of an asset other than cash are included as of the date on which the acquisition is recognised; and

f. Equity shares issued for the rendering of services to the enterprise are included as the services are rendered.

In these and other cases, the timing of the inclusion of equity shares is determined by the specific terms and conditions attaching to their issue. Due consideration should be given to the substance of any contract associated with the issue.

Illustration 2

Date	Particulars	No. of Shares	Face Value	Paid up Value
1st January	**Balance at beginning of year**	**1,800**	**Rs.10**	**Rs.10**
31st October	**Issue of shares**	**600**	**Rs.10**	**Rs.5**

SHRESHTA

Calculate Weighted Number of Shares.

Solution

Assuming that partly paid shares are entitled to participate in the dividend to the extent of amount paid, number of partly paid equity shares would be taken as 300 for the purpose of calculation of earnings per share.

Computation of weighted average would be as follows:

(1,800 x 12/12) + (300 x 2/12) = 1,850 shares.

Illustration 3

Net profit for the year 20X1	**Rs.18,00,000**
Net profit for the year 20X2	**Rs.60,00,000**

No. of equity shares outstanding until 30th September 20X2 20,00,000

Bonus issue 1st October 20X2 was 2 equity shares for each equity share outstanding at 30th September, 20X2

Calculate Basic Earnings Per Share.

Solution

No. of Bonus Issue 20,00,000 x 2 = 40,00,000 shares

Earnings per share for the year 20X2 $\frac{\text{Rs.}60{,}00{,}000}{(20{,}00{,}000 + 40{,}00{,}000)}$ = Rs.1.00

Adjusted earnings per share for the year 20X1 $\frac{\text{Rs.}18{,}00{,}000}{(20{,}00{,}000 + 40{,}00{,}000)}$ = Rs.0.30

Since the bonus issue is an issue without consideration, the issue is treated as if it had occurred prior to the beginning of the year 20X1, the earliest period reported.

Illustration 4

Net profit for the year 20X1	**Rs.11,00,000**
Net profit for the year 20X2	**Rs.15,00,000**
No. of shares outstanding prior to rights issue	**5,00,000 shares**
Rights issue price	**Rs.15.00**
Last date to exercise rights	**1st March 20X2**

Rights issue is one new share for each five outstanding (i.e. 1,00,000 new shares) Fair value of one equity share immediately prior to exercise of rights on 1st March 20X2 was Rs.21.00. Compute Basic Earnings Per Share

SHRESHTA

Solution

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

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

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

Computation of adjustment factor:

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

Computation of earnings per share:

EPS for the year 20X1 as originally reported: Rs.11,00,000/5,00,000 shares = Rs.2.20

EPS for the year 20X1 restated for rights issue: Rs.11,00,000/ (5,00,000 shares x 1.05)

= Rs.2.10

EPS for the year 20X2 including effects of rights issue:

(5,00,000 x 1.05 x 2/12) + (6,00,000 x 10/12) = 5,87,500 shares

EPS = 15,00,000/5,87,500 = Rs.2.55

SHRESHTA

Illustration 5

Net profit for the current year	**Rs.1,00,00,000**
No. of equity shares outstanding	**50,00,000**
Basic earnings per share	**Rs.2.00**
No. of 12% convertible debentures of Rs.100 each	**1,00,000**
Each debenture is convertible into 10 equity shares	
Interest expense for the current year	**Rs.12,00,000**
Tax relating to interest expense (30%)	**Rs.3,60,000**

Compute Diluted Earnings Per Share.

Solution

Adjusted net profit for the current year (1,00,00,000 + 12,00,000 – 3,60,000) = Rs.1,08,40,000

No. of equity shares resulting from conversion of debentures: 10,00,000 Shares

No. of equity shares used to compute diluted EPS: (50,00,000 + 10,00,000) = 60,00,000

Shares Diluted earnings per share: (1,08,40,000/60,00,000) = Rs.1.81

Illustration 6

Net profit for the year 20X1	Rs.12,00,000
Weighted average number of equity shares outstanding during the year 20X1	5,00,000 shares
Average fair value of one equity share during the year 20X1	Rs.20.00
Weighted average number of shares under option during the year 20X1	1,00,000 shares
Exercise price for shares under option during the year 20X1	Rs.15.00

Compute Basic and Diluted Earnings Per Share.

Solution

Computation of earnings per share

	Earnings Rs.	Shares	Earnings/Share Rs.
Net profit for the year 20X1	12,00,000		
Weighted average no. of shares during year 20X1		5,00,000	
Basic earnings per share			2.40
Number of shares under option		1,00,000	
Number of shares that would have been issued at fair value (100,000 x 15.00)/20.00		(75,000)	
Diluted earnings per share	12,00,000	5,25,000	2.29

SHRESHTA

Illustration 7

X Limited, during the year ended March 31, 20X1, has income from continuing ordinary operations of Rs.2,40,000, a loss from discontinuing operations of Rs. 3,60,000 and accordingly a net loss of Rs.1,20,000. The Company has 1,000 equity shares and 200 potential equity shares outstanding as at March 31, 20X1.

You are required to compute Basic and Diluted EPS?

Solution

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

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

TEST YOUR KNOWLEDGE

MCQs

1. **AB Company Ltd. had 1,00,000 shares of common stock outstanding on January 1. Additional 50,000 shares were issued on July 1, and 25,000 shares were reacquired on September 1. The weighted average number of shares outstanding during the year on Dec. 31 is**
   a. **1,40,000 shares**
   b. **1,25,000 shares**
   c. **1,16,667 shares**
   d. **1,20,000 shares**

2. **As per AS 20, potential equity shares should be treated as dilutive when, and only when, their conversion to equity shares would**
   a. **Decrease net profit per share from continuing ordinary operations.**
   b. **Increase net profit per share from continuing ordinary operations.**
   c. **Make no change in net profit per share from continuing ordinary operations.**
   d. **Decrease net loss per share from continuing ordinary operations.**

3. **As per AS 20, equity shares which are issuable upon the satisfaction of certain conditions resulting from contractual arrangements are**
   a. **Dilutive potential equity shares**
   b. **Contingently issuable shares**
   c. **Contractual issued shares**
   d. **Potential equity shares**

SHRESHTA

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

5. **Partly paid up equity shares are:**
   a. **Always considered as a part of Basic EPS.**
   b. **Always considered as a part of Diluted EPS.**

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

ANSWERS/HINTS

1.	**c.**	1,16,667 shares
2.	**a.**	Decrease net profit per share from continuing ordinary operations.
3.	**b.**	Contingently issuable shares
4.	**b.**	Considered from the beginning of the year till the date they are cancelled.
5.	**c.**	Depending upon the entitlement of dividend to the shareholder, it will be considered as a part of Basic or Diluted EPS as the case may be.

THEORETICAL QUESTIONS

Q.NO.1. In the following list of shares issued, for the purpose of calculation of weighted average number of shares, from which date weight is to be considered:

i. **Equity Shares issued in exchange of cash,**
ii. **Equity Shares issued as a result of conversion of a debt instrument,**
iii. **Equity Shares issued in exchange for the settlement of a liability of the enterprise,**
iv. **Equity Shares issued for rendering of services to the enterprise,**
v. **Equity Shares issued in lieu of interest and/or principal of an other financial instrument,**
vi. **Equity Shares issued as consideration for the acquisition of an asset other than in cash. Also define Potential Equity Share.**

Also define Potential Equity Share.

ANSWER

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

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

A Potential Equity Share is a financial instrument or other contract that entitles or may entitle its holder to equity shares.

SHRESHTA

Q.NO.2. Stock options have been granted by AB Limited to its employees and they vest equally over 5 years, i.e., 20 per cent at the end of each year from the date of grant. The options will vest only if the employee is still employed with the company at the end of the year. If the employee leaves the company during the vesting period, the options that have vested can be exercised, while the others would lapse. Currently, AB Limited includes only the vested options for calculating Diluted EPS.

ANSWER

As per AS 20 "A potential equity share is a financial instrument or other contract that entitles, or may entitle, its holder to equity shares".

Options including employee stock option plans under which employees of an enterprise are entitled to receive equity shares as part of their remuneration and other similar plans are examples of potential equity shares. Further, for the purpose of calculating diluted earnings per share, the net profit or loss for the period attributable to equity shareholders and the weighted average number of shares outstanding during the period should be adjusted for the effects of all dilutive potential equity shares.

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

SHRESHTA

Q.NO.3. Explain why the bonus issue of shares and the shares issue at full market price are treated differently in the calculation of the basic earnings per share?

ANSWER

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

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

PRACTICAL QUESTIONS

Q.NO.1. NAT, a listed entity, as on 1st April, 20X1 had the following capital structure:

Particulars	Rs.
10,00,000 Equity Shares having face value of Rs.1 each	**10,00,000**
10,00,000 8% Preference Shares having face value of Rs.10 each	**1,00,00,000**

During the year 20X1-20X2, the company had profit after tax of Rs. 90,00,000.

On 1st January, 20X2, NAT made a bonus issue of one equity share for every 2 equity shares outstanding as at 31st December, 20X1.

On 1st January, 20X2, NAT issued 2,00,000 equity shares of Rs. 1 each at their full market price of Rs. 7.60 per share.

NAT's shares were trading at Rs. 8.05 per share on 31st March, 20X2.

Further it has been provided that the basic earnings per share for the year ended 31st March, 20X1 was previously reported at Rs. 62.30.

You are required to:

i. **Calculate the basic earnings per share to be reported in the financial statements of NAT for the year ended 31st March, 20X2 including the comparative figure, in accordance with AS-20 Earnings Per Share.**

ii. **Explain why the bonus issue of shares and the shares issue at full market price are treated differently in the calculation of the basic earnings per share?**

SOLUTION

i. **Computation of Basic Earnings per share for the year ended 31st March, 20X2:**

(Including the comparative figure)

Working Note – I:

Earnings for the year ended 31st March, 20X1:

= EPS x Number of shares outstanding during 20X0-20X1

= Rs.62.30 x 10,00,000 equity shares

= Rs.6,23,00,000

Adjusted/Restated Earnings per share for the year ended 31st March 20X1:

(after taking into consideration bonus issue)

Adjusted/Restated Basic EPS:

= Earnings for the year 20X0-20X1 / (Total outstanding shares +Bonus issue)

= Rs.6,23,00,000 / (10,00,000+ 5,00,000)

= Rs.6,23,00,000 / 15,00,000

= Rs.41.53 per share

SHRESHTA

Computation of Basic EPS for the year 20X1-20X2:

Basic EPS = (Total Earnings – Preference Shares Dividend) / (Total shares outstanding at the beginning + Bonus issue + weighted average of the shares issued in January, 20X2)

= (Rs.90,00,000 – Rs. (1,00,00,000 x 8%)) / (10,00,000 + 5,00,000 + (2,00,000 x 3/12))

= Rs.82,00,000 / 15,50,000 shares

= Rs.5.29 per share

ii. In case of a bonus issue, equity shares are issued to existing shareholders for no additional consideration. Therefore, the number of equity shares outstanding is increased without an increase in resources. Since the bonus issue is an issue without consideration, the issue is treated as if it had occurred prior to the beginning of the year 20X1, the earliest period reported. However, the share issued at full market price does not carry any bonus element and usually results in a proportionate change in the resources available to the enterprise. Therefore, it is taken into consideration from the time it has been issued i.e. the time- weighting factor is considered based on the specific shares outstanding as a proportion of the total number of days in the period.

SHRESHTA

Q.NO.2. X Ltd. supplied the following information. You are required to compute the basic earnings per share:

(Accounting year 1.1.20X1– 31.12.20X1)

Net Profit	**:**	**Year 20X1: Rs.20,00,000** **Year 20X2: Rs.30,00,000**
No. of shares outstanding prior to Right Issue	**:**	**10,00,000 shares**
Right Issue	**:**	**One new share for each four outstanding i.e., 2,50,000 shares.** **Right Issue price – Rs.20** **Last date of exercise rights– 31.3.20X2.**
Fair rate of one Equity share immediately prior to exercise of rights on 31.3.20X2	**:**	**Rs.25**

SOLUTION

Computation of Basic Earnings per Share

(as per paragraphs 10 and 26 of AS 20 on Earnings Per Share)

	Year 20X1 Rs.	Year 20X2 Rs.
EPS for the year 20X1 as originally reported		
$\frac{\text{Net profit of the year attributable to equity share holders}}{\text{weighted average number of equity shares outstanding during the year}}$		
= (Rs.20,00,000 / 10,00,000 shares)	2.00	
EPS for the year 20X1 restated for rights issue		
= [Rs.20,00,000 / (10,00,000 shares × 1.04*)]	1.91 (approx.)	
EPS for the year 20X2 including effects of rights Issue		
$\frac{\text{Rs.30,00,000}}{\left(10,00,000\text{shares}\times 1.04\times\frac{3}{12}\right)+\left(12,50,000\text{shares}\times\frac{9}{12}\right)}$		
$\frac{\text{Rs.30,00,000}}{11,97,500\text{shares}}$		2.51 (approx.)

Working Notes:

1. Computation of theoretical ex-rights fair value per share

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

$$= \frac{(\text{Rs.}25\times 10,00,000\text{shares})+(\text{Rs.}20\times 2,50,000\text{shares})}{10,00,000\text{shares}+2,50,000\text{shares}} = \frac{\text{Rs.3,00,00,000}}{12,50,000\text{shares}} = \text{Rs.24}$$

2. Computation of adjustment factor

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

$$= \frac{\text{Rs.25}}{\text{Rs.24(Refer Working Note 1)}} = 1.04 \text{(approx.)}$$

SHRESHTA

Q.NO.3. On 1 st April, 20X1 a company had 6,00,000 equity shares of Rs.10 each (Rs.5 paid up by all shareholders). On 1st September, 20X1 the remaining Rs.5 was called up and paid by all shareholders except one shareholder having 60,000 equity shares. The net profit for the year ended 31st March, 20X2 was Rs.21,96,000 after considering dividend on preference shares of Rs.3,40,000.

You are required to compute Basic EPS for the year ended 31st March, 20X2 as per Accounting Standard 20 "Earnings Per Share".

SOLUTION

Basic Earnings per share (EPS) =

$$= \frac{\text{Net profit attributable to equity shareholders}}{\text{Weighted average number of equity shares outstanding during the year}}$$

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

Working Note:

Calculation of weighted average number of equity shares

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

Assuming that the partly paid shares are entitled to participate in the dividend to the extent of amount paid, weighted average number of shares will be calculated as follows:

Date	No. of equity shares	Amount paid per share	Weighted average no. of equity shares
	Rs.	Rs.	Rs.
1.4.20X1	6,00,000	5	6,00,000 x 5/10 x 5/12 = 1,25,000
1.9.20X1	5,40,000	10	5,40,000 x 7/12 = 3,15,000
1.9.20X1	60,000	5	60,000 x 5/10 x 7/12 = 17,500
Total weighted average equity shares			**4,57,500**

Q.NO.4. No. of equity shares outstanding = 30,00,000

Basic earnings per share Rs.5.00

No. of 12% convertible debentures of Rs.100 each; 50,000

Each debenture is convertible into 10 equity shares

Tax Rate 30%

Compute Diluted Earnings per Share.

Working notes should form part of the answer.

<u>SOLUTION</u>

Earnings for the year:

= No. of Shares x Basic EPS

= 30,00,000 shares x Rs.5 per share = Rs.1,50,00,000

Computation of Adjusted Net Profit:

= Earnings for the year + Interest on debentures net of tax

= 1,50,00,000 + (6,00,000 - 1,80,000) = Rs.1,54,20,000

Computation of Adjusted Denominator:

No. of equity shares resulting from conversion of debentures:

= 50,000 x 10 shares = 5,00,000 shares

No. of equity shares for diluted EPS = 30,00,000 + 5,00,000 = 35,00,000 shares

Computation of Diluted EPS:

= Rs.1,54,20,000/35,00,000 shares = Rs.4.4 per share.

SHRESHTA

UNIT 6: ACCOUNTING STANDARD 24: DISCONTINUING OPERATIONS

LEARNING OUTCOMES

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

- Meaning of Discontinuing Operation;
- Definition of Initial Disclosure Event;
- Recognition and Measurement principles;
- Presentation and Disclosures as required under the standard.

6.1 INTRODUCTION

Imagine that a large company selling several products in the market decides to discontinue the sale of one of its key product as it plans to sell that portion of its business to another entity.

Ideally, this information should be disclosed to primary stakeholders as they would take economic decisions based on the performance of the remaining portion of the business that is expected to be continued by the company in future. Therefore, the presentation requirements of such discontinuing operations becomes relevant and the aspects of AS 24 need to be understood. AS 24 is applicable to all discontinuing operations.

The objective of AS 24 is to establish principles for reporting information about discontinuing operations, thereby enhancing the ability of users of financial statements to make projections of an enterprise's cash flows, earnings-generating capacity, and financial position by segregating information about discontinuing operations from information about continuing operations.

6.2 DISCONTINUING OPERATION

A discontinuing operation is a component of an enterprise:

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

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

  ii. sposing of piecemeal, such as by selling off the component's assets and settling its liabilities individually; or

  iii. Terminating through abandonment; and

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

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

SHRESHTA

Example 1

Co XY runs a famous chain of restaurants. It decides to sell its stake in one of the restaurant. This restaurant contributes around 5% of total revenue to the entire business. XY does not intend to sell any other restaurant as part of its strategy.

In the above case, the sale of one restaurant out of the chain does not constitute disposal of business under a single plan, or a portion that represents a major line of business or geographical area of operations. Thus, it cannot be regarded as a discontinuing operation.

Example 2

Group MN operates in various industries including Hotels, Airlines and Software through its subsidiaries. It has decided to sell its Airline business to be able to concentrate on other verticals. As a result, it has started to sell its aircrafts and paying off the associated liabilities. During the year, it has sold off 5 aircrafts out of the fleet of 50 aircrafts so far as part of the sale. The Airline business constitutes 25% of total group revenue.

In the above case, Airline business may be considered as **discontinuing operation.** This is due to the fact that the assets are sold off as part of a single plan, and that the business represents a separate major line of business, and can be distinguished both operationally and for financial reporting purposes.

Separate major line of business or geographical area of operations:

- A reportable business segment or geographical segment as defined in AS 17 'Segment Reporting', would normally satisfy criteria and it would represent a **separate major line of business or geographical area of operations.**
- A part of such a segment may also satisfy criteria and it would represent a separate major line of business or geographical area of operations
- For an enterprise that **operates in a single business or geographical segment** which does not report segment information, **a major product or service line may also satisfy the criteria** (see example below)

Example 3 Entity RT operates in a single state and is trading in 3 products – X, Y and Z. Details with respect to the performance of each of the products are as under:

Particulars	X	Y	Z	Total
Sales	1,00,000	14,00,000	20,00,000	35,00,000
Cost of Goods Sold	(80,000)	(10,80,000)	(14,40,000)	(26,00,000)
Gross Margin	20,000	3,20,000	5,60,000	9,00,000
Operational Expenses	(15,000)	(1,70,000)	(3,60,000)	(5,45,000)
Profit before Tax	5,000	1,50,000	2,00,000	3,55,000

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RT has decided to sell the business relating to Product Y to another entity. Since Product Y constitutes a major product, it may be considered as a discontinuing operations.

Instead of disposing of a component substantially in its entirety, an enterprise may discontinue and dispose of the component by selling its assets and settling its liabilities piecemeal (individually or in small groups). For piecemeal disposals, while the overall result may be a net gain or a net loss, the sale of an individual asset or settlement of an individual liability may have the opposite effect. Moreover, there is no specific date at which an overall binding sale agreement is entered into. Rather, the sales of assets and settlements of liabilities may occur over a period of months or perhaps even longer. Thus, disposal of a component may be in progress at the end of a financial reporting period. To qualify as a discontinuing operation, the disposal must be pursuant to a single coordinated plan.

An enterprise may terminate an operation by abandonment without substantial sales of assets. An abandoned operation would be a discontinuing operation if it satisfies the criteria in the definition. However, changing the scope of an operation or the manner in which it is conducted is not abandonment because that operation, although changed, is continuing.

Example 4

GH, a large car manufacturing company, decides to discontinue its manufacturing operations relating to the diesel cars production. It plans to restructure the business by revamping its existing operations, and starting new manufacturing process for manufacture and sale of electric vehicles.

In the above example, it needs to be evaluated whether the restructuring is a result of continuing operations, or termination of existing operations, and accordingly it can be concluded whether it is a case of discontinuing operations or not.

Examples of activities that do not necessarily satisfy criterion (a) of the definition, but that might do so in combination with other circumstances, include:

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

b. Discontinuing, even if relatively abruptly, several products within an ongoing line of business;

c. Shifting of some production or marketing activities for a particular line of business from one location to another; and

d. Closing of a facility to achieve productivity improvements or other cost savings.

An example in relation to consolidated financial statements is selling a subsidiary whose activities are similar to those of the parent or other subsidiaries.

A component can be distinguished operationally and for financial reporting purposes - criterion (c) of the definition of a discontinuing operation - if all the following conditions are met:

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a. The operating assets and liabilities of the component can be directly attributed to it.
b. Its revenue can be directly attributed to it.
c. At least a majority of its operating expenses can be directly attributed to it. Assets, liabilities, revenue, and expenses are directly attributable to a component if they would be eliminated when the component is sold, abandoned or otherwise disposed of. If debt is attributable to a component, the related interest and other financing costs are similarly attributed to it. Discontinuing operations are infrequent events, but this does not mean that all infrequent events are discontinuing operations. The fact that a disposal of a component of an enterprise is classified as a discontinuing operation under AS 24 does not, in itself, bring into question the enterprise's ability to continue as a going concern.

6.3 INITIAL DISCLOSURE EVENT

With respect to a discontinuing operation, the initial disclosure event is the occurrence of one of the following, whichever occurs earlier:

a. The enterprise has entered into a binding sale agreement for substantially all of the assets attributable to the discontinuing operation; or
b. The enterprise's board of directors or similar governing body has both
   i. approved a detailed, formal plan for the discontinuance and
   ii. made an announcement of the plan.

A detailed, formal plan for the discontinuance normally includes:

- identification of the major assets to be disposed of;
- the expected method of disposal;
- the period expected to be required for completion of the disposal;
- the principal locations affected;
- the location, function, and approximate number or employees who will be compensated for terminating their services; and
- the estimated proceeds or salvage to be realised by disposal.

An enterprise’s board of directors or similar governing body is considered to have made the announcement of a detailed, formal plan for discontinuance, if it has announced the main features of the plan to those affected by it, such as, lenders, stock exchanges, trade payables, trade unions, etc. in a sufficiently specific manner so as to make the enterprise demonstrably committed to the discontinuance.

6.4 RECOGNITION AND MEASUREMENT

For recognising and measuring the effect of discontinuing operations, this AS does not provide any guidelines, but for the purpose the relevant Accounting Standards should be referred.

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6.5 PRESENTATION AND DISCLOSURE

6.5.1 Initial Disclosure

An enterprise should include the following information relating to a discontinuing operation in its financial statements beginning with the financial statements for the period in which the initial disclosure event occurs:

- **a.** A description of the discontinuing operation(s);
- **b.** The business or geographical segment(s) in which it is reported as per AS 17;
- **c.** The date and nature of the initial disclosure event;
- **d.** The date or period in which the discontinuance is expected to be completed if known or determinable;
- **e.** The carrying amounts, as of the balance sheet date, of the total assets to be disposed of and the total liabilities to be settled;
- **f.** The amounts of revenue and expenses in respect of the ordinary activities attributable to the discontinuing operation during the current financial reporting period;
- **g.** The amount of pre-tax profit or loss from ordinary activities attributable to the discontinuing operation during the current financial reporting period, and the income tax expense related thereto;
- **h.** The amounts of net cash flows attributable to the operating, investing, and financing activities of the discontinuing operation during the current financial reporting period;

6.5.2 Disclosures Other Than Initial Disclosures Note

All the disclosures above should be presented in the notes to the financial statements except for amounts pertaining to pre-tax profit/loss of the discontinuing operation and the income tax expense thereon (second last bullet above) which should be shown on the face of the statement of profit and loss.

6.5.3 Other disclosures

When an enterprise disposes of assets or settles liabilities attributable to a discontinuing operation or enters into binding agreements for the sale of such assets or the settlement of such liabilities, it should include, in its financial statements, the following information when the events occur:

- **a.** For any gain or loss that is recognised on the disposal of assets or settlement of liabilities attributable to the discontinuing operation, (i) the amount of the pre-tax gain or loss and (ii) income tax expense relating to the gain or loss and
- **b.** The net selling price or range of prices (which is after deducting expected disposal costs) of those net assets for which the enterprise has entered into one or more binding sale agreements, the expected timing of receipt of those cash flows and the carrying amount of those net assets on the balance sheet date.

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6.6 UPDATING THE DISCLOSURES

In addition to these disclosures, an enterprise should include, in its financial statements, for periods subsequent to the one in which the initial disclosure event occurs, a description of any significant changes in the amount or timing of cash flows relating to the assets to be disposed or liabilities to be settled and the events causing those changes.

The disclosures should continue in financial statements for periods up to and including the period in which the discontinuance is completed. Discontinuance is completed when the plan is substantially completed or abandoned, though full payments from the buyer(s) may not yet have been received.

If an enterprise abandons or withdraws from a plan that was previously reported as a discontinuing operation, that fact, reasons therefore and its effect should be disclosed.

6.7 SEPARATE DISCLOSURE FOR EACH DISCONTINUING OPERATION

Any disclosures required by AS 24 should be presented separately for each discontinuing operation.

6.8 PRESENTATION OF THE REQUIRED DISCLOSURES

The above disclosures should be presented in the notes to the financial statements except the following which should be shown on the face of the statement of profit and loss:

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

b. The amount of the pre-tax gain or loss recognised on the disposal of assets or settlement of liabilities attributable to the discontinuing operation.

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6.9 RESTATEMENT OF PRIOR PERIODS

Comparative information for prior periods that is presented in financial statements prepared after the initial disclosure event should be restated to segregate assets, liabilities, revenue, expenses, and cash flows of continuing and discontinuing operations in a manner similar to that mentioned above.

6.10 DISCLOSURE IN INTERIM FINANCIAL REPORTS

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

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

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

TEST YOUR KNOWLEDGE

MCQs

1. **AB decided to dispose of its Clothing division as part of its long-term strategy.**
   a. **Date of Board approval - 1st March 20X1;**
   b. **Date of formal announcement made to affected parties - 15th March 20X1.**
   c. **Date of Binding Sale agreement – 1st July 20X1;**
   d. **Reporting date – 31st March 20X1**

2. **The date of initial disclosure event would be:**
   a. **1st March 20X1**
   b. **15th March 20X1**
   c. **31st March 20X1**
   d. **31st July 20X1**

3. **To qualify as a component that can be distinguished operationally and for financial reporting purposes, the condition(s) to be met is (are):**
   a. **The operating assets and liabilities of the component can be directly attributed to it.**
   b. **Its revenue can be directly attributed to it.**
   c. **At least a majority of its operating expenses can be directly attributed to it.**
   d. **All of the above**

4. **Identify which of the following statements is incorrect?**
   a. **A discontinuing operation is a component of an enterprise that represents a separate major line of business or geographical area of operations.**
   b. **A discontinuing operation is a component of an enterprise that can be distinguished operationally and for financial reporting purposes.**
   c. **A discontinuing operation is a component of an enterprise that may or may not be distinguished operationally and for financial reporting purposes.**
   d. **A discontinuing operation may be disposed of in its entirety or piecemeal, but always pursuant to an overall plan to discontinue the entire component.**

5. **Identify the incorrect statement.**
   a. **Discontinuing operations are infrequent events, but this does not mean that all infrequent events are discontinuing operations.**

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b. **The fact that a disposal of a component of an enterprise is classified as a discontinuing operation under AS 24 would always raise a question regarding the enterprise's ability to continue as a going concern.**

c. **For recognising and measuring the effect of discontinuing operations, AS 24 does not provide any guidelines, but for the purpose the relevant Accounting Standards should be referred.**

d. **An enterprise shall include a description of the discontinuing operation, in its financial statements beginning with the financial statements for the period in which the initial disclosure event occurs.**

ANSWERS/HINTS

MCQs

1.	**b.**	Date of formal announcement made to affected parties - 15th March 20X1.
2.	**d.**	All of the above
3.	**c.**	A discontinuing operation is a component of an enterprise that may or may not be distinguished operationally and for financial reporting purposes.
4.	**b.**	The fact that a disposal of a component of an enterprise is classified as a discontinuing operation under AS 24 would always raise a question regarding the enterprise's ability to continue as a going concern.

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THEORETICAL QUESTIONS

Q.NO.1.

i. **What are the disclosure and presentation requirements of AS 24 for discontinuing operations?**

ii. **Give four examples of activities that do not necessarily satisfy criterion (a) of paragraph 3 of AS 24, but that might do so in combination with other circumstances.**

ANSWER

i. An enterprise should include prescribed information relating to a discontinuing operation in its financial statements beginning with the financial statements for the period in which the initial disclosure event (as defined in paragraph 15 of AS 24) occurs. For details, please refer Section 6.5 of this Chapter above.

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

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

b. Discontinuing, even if relatively abruptly, several products within an ongoing line of business;

c. Shifting of some production or marketing activities for a particular line of business from one location to another; and
d. Closing of a facility to achieve productivity improvements or other cost savings.

Q.NO.2. What are the initial disclosure requirements of AS 24 for discontinuing operations?

ANSWER

An enterprise should include the following information relating to a discontinuing operation in its financial statements beginning with the financial statements for the period in which the initial disclosure event occurs:

a. A description of the discontinuing operation(s)

b. The business or geographical segment(s) in which it is reported as per AS 17.

c. The date and nature of the initial disclosure event.

d. The date or period in which the discontinuance is expected to be completed if known or determinable

e. The carrying amounts, as of the balance sheet date, of the total assets to be disposed of and the total liabilities to be settled.

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

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

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

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PRACTICAL QUESTIONS

Q.NO.1. Rohini Limited is in the business of manufacture of passenger cars and commercial vehicles. The Company is working on a strategic plan to close the production of passenger cars and to produce only commercial vehicles over the coming 5 years. However, no specific plans have been drawn up for sale of neither the division nor its assets. As part of its prospective plan it will reduce the production of passenger cars by 20% annually. It also plans to establish another new factory for the manufacture of commercial vehicles and transfer surplus employees in a phased manner.

You are required to comment:

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

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

III. Would your answer to (ii) above be different if the Company resolves to sell the assets of the passenger car division in a phased but time bound manner?

SOLUTION

I. A discontinuing operation is a component of an enterprise:

- **a.** that the enterprise, pursuant to a single plan, is:
  - **i.** disposing of substantially in its entirety, such as by selling the component in a single transaction or by demerger or spin-off of ownership of the component to the enterprise's shareholders; or
  - **ii.** disposing of piecemeal, such as by selling off the component's assets and settling its liabilities individually; or
  - **iii.** terminating through abandonment; and
- **b.** that represents a separate major line of business or geographical area of operations; and
- **c.** that can be distinguished operationally and for financial reporting purposes.

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

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

- **i.** Gradual or evolutionary phasing out of a product line or class of service;
- **ii.** Shifting of some production or marketing activities for a particular line of business from one location to another; and

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iii. Closing of a facility to achieve productivity improvements or other cost savings. In this case, it cannot be considered as Discontinuing Operation as per AS-24 as the companies' strategic plan has no final approval from the board through a resolution and there is no specific time bound activities like shifting of assets and employees. Moreover, the new segment i.e. commercial vehicle production line in a new factory has not started.

II. No, the resolution is silent about stoppage of the Car segment in definite time period. Though, sale of some assets and some transfer proposal were passed through a resolution to the new factory, but the closure road map and new segment starting roadmap are missing. Hence AS 24 will not be applicable and it cannot be considered as Discontinuing operations.

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

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

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5. ASSETS BASED ACCOUNTING STANDARDS

UNIT 1: ACCOUNTING STANDARD 2 VALUATION OF INVENTORY

LEARNING OUTCOMES

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

- Definition of Inventory;
- Measurement of Inventories;
- What is included in Cost of Inventories;
- Exclusions from the Cost of Inventories;
- Cost Formulas;
- Techniques for the Measurement of Cost.

1.1 INTRODUCTION

The accounting treatment for inventories is prescribed in AS 2 (Revised) 'Valuation of Inventories', which provides guidance for determining the value at which inventories, are carried in the financial statements until related revenues are recognised. It also provides guidance on the cost formulas that are used to assign costs to inventories and any write-down thereof to net realisable value.

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1.2 INVENTORIES

AS 2 (Revised) defines inventories as assets held

- for sale in the ordinary course of business, or
- in the process of production for such sale, or
- for consumption in the production of goods or services for sale, including maintenance supplies and consumables other than machinery spares, servicing equipment and standby equipment meeting the definition of Property, plant and equipment.

Inventories encompass goods purchased and held for resale, for example merchandise (goods) purchased by a retailer and held for resale, or land and other property held for resale. Inventories also include finished goods produced, or work in progress being produced, by the enterprise and include materials, maintenance supplies, consumables and loose tools awaiting use in the production process. Inventories do not include spare parts, servicing equipment and standby equipment which meet the definition of property, plant and equipment as per AS 10 (Revised), Property, Plant and Equipment. Such items are accounted for in accordance with Accounting Standard (AS) (Revised) 10, Property, Plant and Equipment.

Following are excluded from the scope of AS 2 (Revised).

a. Work in progress arising under construction contracts, i.e. cost of part construction, including directly related service contracts, being covered under AS 7, Accounting for Construction Contracts; Inventory held for use in construction, e.g. cement lying at the site should however be covered by AS 2 (Revised).

b. Work in progress arising in the ordinary course of business of service providers i.e. cost of providing a part of service. For example, for a shipping company, fuel and stores not consumed at the end of accounting period is inventory but not costs for voyage-in-progress. Work-in-progress may arise for different other services e.g. software development, consultancy, medical services, merchant banking and so on.

c. Shares, debentures and other financial instruments held as stock-in-trade. It should be noted that these are excluded from the scope of AS 13 (Revised) as well. The current Indian practice is however to value them at lower of cost and fair value.

d. Producers' inventories of livestock, agricultural and forest products, and mineral oils, ores and gases to the extent that they are measured at net realisable value in accordance with well established practices in those industries, e.g. where sale is assured under a forward contract or a government guarantee or where a homogenous market exists and there is negligible risk of failure to sell.

The types of inventories are related to the nature of business. The inventories of a trading concern consist primarily of products purchased for resale in their existing form. It may also have an inventory of supplies such as wrapping paper, cartons, and stationery. The inventories of manufacturing concern consist of several types of inventories: raw material (which will become part of the goods to be produced), parts and factory supplies, work-in-process (partially completed products in the factory) and, of course, finished products.

At the year-end every business entity needs to ascertain the closing balance of Inventory which comprise of Inventory of raw material, work-in-progress, finished goods and miscellaneous items. The cost of closing inventory, e.g. cost of closing stock of raw materials, closing work-in-progress and closing finished stock, is a part of costs incurred in the current accounting period that is carried over to next accounting period. Likewise, the cost of opening inventory is a part of costs incurred in the previous accounting period that is brought forward to current accounting period.

Since inventories are assets, and assets are resources expected to generate future economic benefits to the enterprise, the costs to be included in inventory costs, are costs that are expected to generate future economic benefits to the enterprise. Such costs must be costs of acquisition and costs

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incurred in bringing the assets to their present (i) location of the inventory, e.g. freight incurred to carry the materials to factory and (ii) conditions of the inventory, e.g. costs incurred to convert the materials into finished stock. The costs incurred to maintain the inventory, e.g. storage costs, do not generate any extra economic benefits for the enterprise and therefore should not be included in inventory costs unless those costs are necessary in production process prior to a further production stage.

The valuation of inventory is crucial because of its direct impact in measuring profit/loss for an accounting period. Higher the value of closing inventory lower is the cost of goods sold and hence higher is the profit. The principle of prudence demands that no profit should be anticipated while all foreseeable losses should be recognised. Thus, if net realisable value of inventory is less than inventory cost, inventory is valued at net realisable value to reduce the reported profit in anticipation of loss. On the other hand, if net realisable value of inventory is more than inventory cost, the anticipated profit is ignored and the inventory is valued at cost. In short, **inventory is valued at lower of cost and net realisable value**. The standard specifies (i) what the cost of inventory should consist of and (ii) how the net realisable value is determined.

Abnormal gains or losses are not expected to recur regularly. For a meaningful analysis of an enterprise's performance, the users of financial statements need to know the amount of such gains/losses included in current profit/loss. For this reason, instead of taking abnormal gains and losses in inventory costs, these are shown in the Profit and Loss statement in such way that their impact on current profit/loss can be perceived.

Part I of Schedule III to the Companies Act, 2013 prescribes that valuation method should be disclosed for inventory held by companies.

1.3 MEASUREMENT OF INVENTORIES

Inventories should be valued at lower of cost and net realisable value. Net realisable value is the estimated selling price in the ordinary course of business less the estimated costs of completion and the estimated costs necessary to make the sale. The valuation of inventory at lower of cost and net realisable value is based on the view that no asset should be carried at a value which is in excess of the value realisable by its sale or use.

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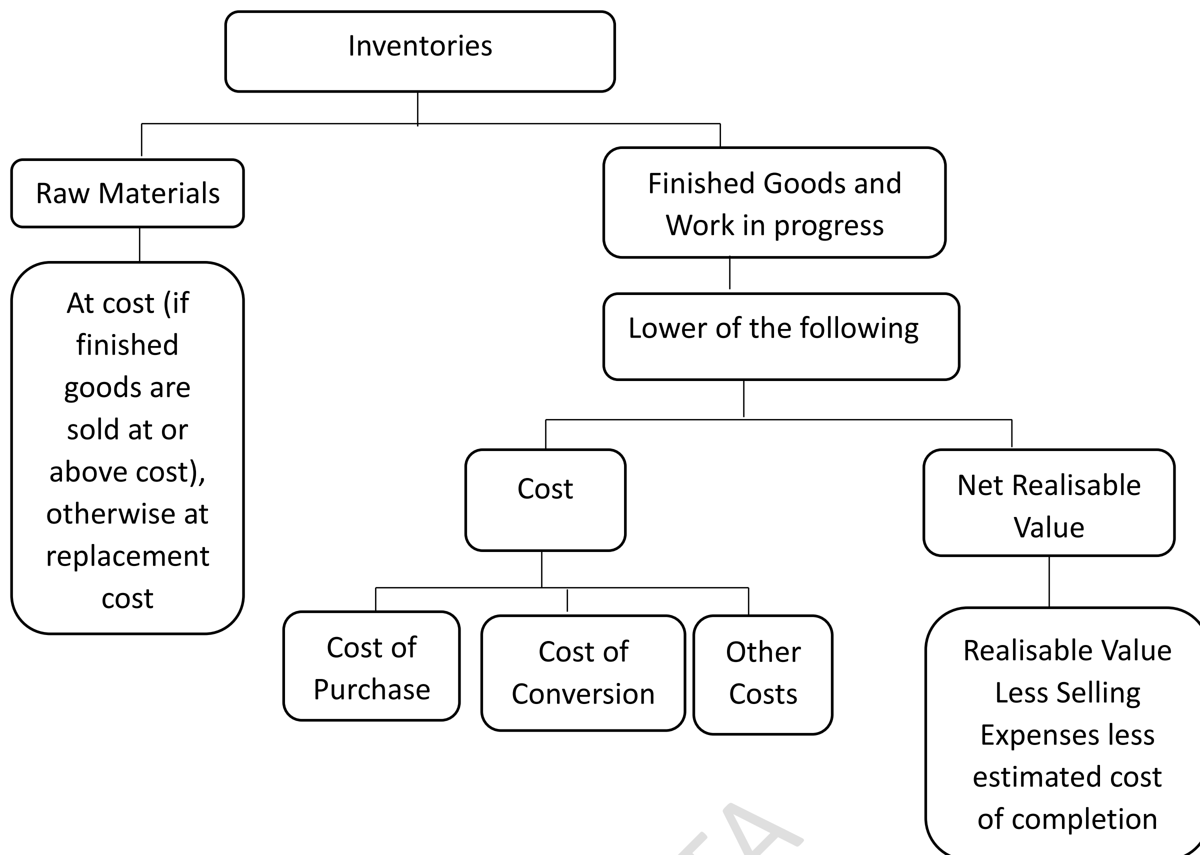

Example 1

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

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

1.4 COSTS OF INVENTORY

Costs of inventories comprise **all costs of purchase, costs of conversion and other costs** incurred in bringing the inventories to their present location and condition.

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1.5 COSTS OF PURCHASE

The costs of purchase consist of the purchase price including duties and taxes (other than those subsequently recoverable by the enterprise from the taxing authorities, and other expenditure directly attributable to the acquisition. Trade discounts, rebates, duty drawbacks and other similar items are deducted in determining the costs of purchase.

1.6 COSTS OF CONVERSION

The costs of conversion include costs directly related to production, e.g. direct labour. They also include overheads, both fixed and variable that are incurred in converting raw material to finished goods.

The fixed production overheads should be absorbed systematically to units of production over normal capacity**. Normal capacity** is the production the enterprise expects to achieve on an average over a number of periods or seasons under normal circumstances, taking into account the loss of capacity resulting from planned maintenance. The **actual level of production** may be used if it approximates the normal capacity. The amount of fixed production overheads allocated to each unit of production should not be increased as a consequence of low production or idle plant. Unallocated overheads (i.e. under recovery) are recognised as an expense in the period in which they are incurred. In periods of abnormally high production, the amount of fixed production overheads allocated to each unit of production is decreased so that inventories are not measured above cost. Variable production overheads are assigned to each unit of production on the basis of the actual use of the production facilities.

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Example 2

ABC Ltd. has a plant with the capacity to produce 1 lac unit of a product per annum and the expected fixed overhead is Rs.18 lacs. Fixed overhead on the basis of normal capacity is Rs.18 (18 lacs/1 lac).

Case 1: Actual production is 1 lac units. Fixed overhead on the basis of normal capacity and actual overhead will lead to same figure of Rs.18 lacs. Therefore, it is advisable to include this on normal capacity.

Case 2: Actual production is 90,000 units. Fixed overhead is not going to change with the change in output and will remain constant at Rs.18 lacs, therefore, overheads on actual basis is Rs.20 per unit (18 lacs/ 90 thousands). Hence by valuing inventory at Rs.20 each for fixed overhead purpose, it will be overvalued and the losses of Rs.1.8 lacs will also be included in closing inventory leading to a higher gross profit then actually earned. Therefore, it is advisable to include fixed overhead per unit

on normal capacity to actual production (90,000 x 18)Rs.16.2 lacs and rest Rs.1.8 lacs should be transferred to Profit & Loss Account.

Case 3: Actual production is 1.2 lacs units. Fixed overhead is not going to change with the change in output and will remain constant at Rs.18 lacs, therefore, overheads on actual basis is Rs.15 (18 lacs/ 1.2 lacs). Hence by valuing inventory at Rs.18 each for fixed overhead purpose, we will be adding the element of cost to inventory which actually has not been incurred. At Rs.18 per unit, total fixed overhead comes to Rs.21.6 lacs whereas, actual fixed overhead expense is only Rs.18 lacs. Therefore, it is advisable to include fixed overhead on actual basis (1.2 lacs x 15) Rs.18 lacs.

1.7 JOINT OR BY-PRODUCTS

In case of joint or by products, the costs incurred up to the stage of split off should be allocated on a rational and consistent basis. The basis of allocation may be sale value at split off point, for example, value of by products, scraps and wastes are usually not material. These are therefore valued at net realisable value. The cost of main product is then valued as joint cost minus net realisable value of by-products, scraps or wastes.

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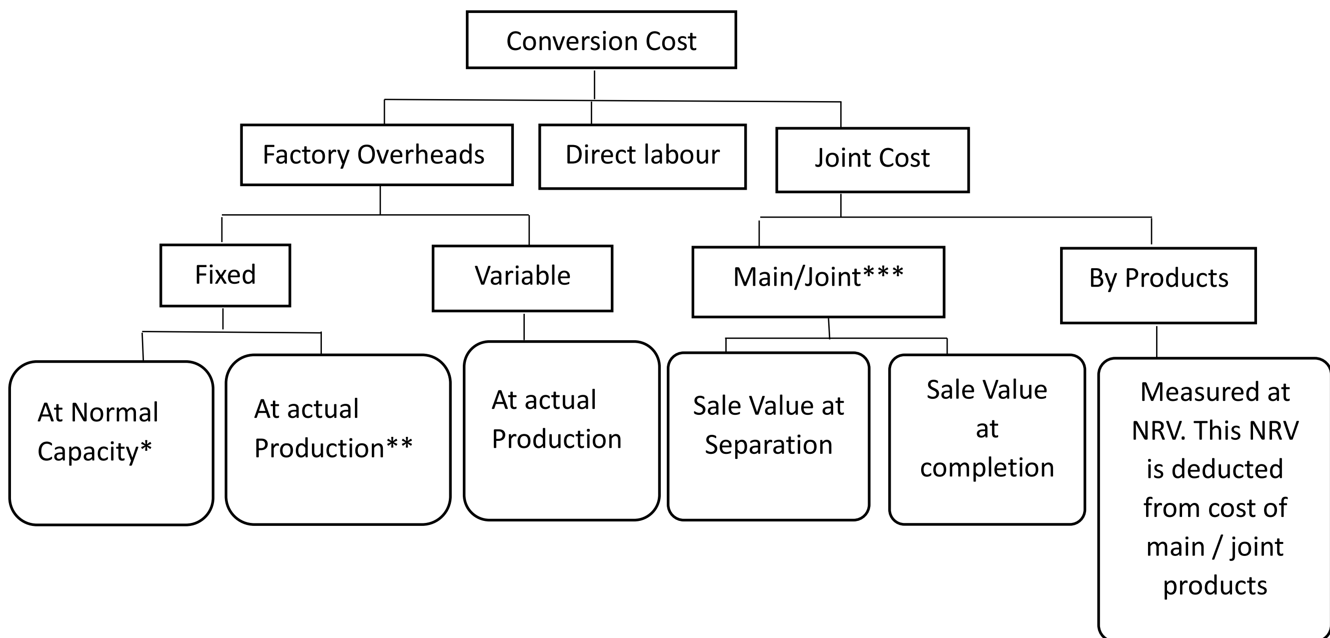
1.8 OTHER COSTS

a. These may be included in cost of inventory provided they are incurred to bring the inventory to their present location and condition. Cost of design, for example, for a custom made unit may be taken as part of inventory cost.

b. Interest and other borrowing costs are usually considered as not relating to bringing the inventories to their present location and condition. These costs are therefore not usually included in cost of inventory. Interests and other borrowing costs however are taken as part of inventory costs, where the inventory necessarily takes substantial period of time for getting ready for intended sale. Example of such inventory is wine.

c. The standard is silent on treatment of amortisation of intangibles for ascertaining inventory costs. It nevertheless appears that amortisation of intangibles related to production, e.g. patents right of production or copyright for a publisher should be taken as part of inventory costs.

d. Exchange differences are not taken in inventory costs.



*When actual production is almost equal or lower than normal capacity.

** When actual production is higher than normal capacity.

*** Allocation at reasonable and consistent basis.

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1.9 EXCLUSIONS FROM THE COST OF INVENTORIES

In determining the cost of inventories, it is appropriate to exclude certain costs and recognise them as expenses in the period in which they are incurred. Examples of such costs are:

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

b. Storage costs, unless the production process requires such storage;

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

d. Selling and distribution costs.

1.10 COST FORMULA

Mostly inventories are purchased / made in different lots and unit cost of each lot frequently differs. In all such circumstances, determination of closing inventory cost requires identification of units in stock to have come from a particular lot. This specific identification is best wherever possible. In all other cases, the cost of inventory should be determined by the First-In First-Out (FIFO), or Weighted Average cost formula. The formula used should reflect the fairest possible approximation to the cost incurred in bringing the items of inventory to their present location and condition.

1.11 OTHER TECHNIQUES OF COST MEASUREMENT

a. Instead of actual, the standard costs may be taken as cost of inventory provided standards fairly approximate the actual. Such standards (for finished or partly finished units) should be set in the light of normal levels of material consumption, labour efficiency and capacity utilisation. The standards so set should be regularly reviewed and if necessary, be revised to reflect current conditions.

b. In retail business, where a large number of rapidly changing items are traded, the actual costs of items may be difficult to determine. The units dealt by a retailer however, are usually sold for similar gross margins and a retail method to determine cost in such retail trades makes use of the fact. By this method, cost of inventory is determined by reducing sale value of unsold stock by appropriate average percentage of gross margin.

Example 3

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

Cost of closing inventory is shown below:

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

Note: Margin is on sales and mark-up is on cost.

1.12 ESTIMATES OF NET REALISABLE VALUE

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

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1.13 COMPARISON OF COST AND NET REALISABLE VALUE

The comparison between cost and net realisable value should be made on item-by-item basis. In some cases nevertheless, it may be appropriate to group similar or related items.

Example 4

The cost, net realisable value and inventory value of two items that a company has in its inventory are given below:

	Cost	Net Realisable Value	Inventory Value
	Rs.	**Rs.**	**Rs.**
Item 1	50,000	45,000	45,000
Item 2	20,000	24,000	20,000
Total	70,000	69,000	65,000

Estimates of NRV should be based on evidence available at the time of estimation.

Net realisable value is the estimated selling price in the ordinary course of business less the estimated costs of completion and the estimated costs necessary to make the sale. AS 2 (Revised) also provides that estimates of net realisable value are to be based on the most reliable evidence available at the time the estimates are made as to the amount the inventories are expected to realise. These estimates take into consideration fluctuations of price or cost directly relating to events occurring after the balance sheet date to the extent that such events confirm the conditions existing at the balance sheet date.

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1.14 NRV OF MATERIALS HELD FOR USE OR DISPOSAL

Materials and other supplies held for use in the production of inventories are **not** written down below cost if the selling price of finished product containing the material exceeds the cost of the finished product. The reason is, as long as these conditions hold the material realises more than its cost as shown below.

Review of net realisable value at each balance sheet date

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

1.15 DISCLOSURES

The financial statements should disclose:

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

b. The total carrying amount of inventories together with a classification appropriate to the enterprise.

Information about the carrying amounts held in different classifications of inventories and the extent of the changes in these assets is useful to financial statement users. Common classifications of inventories are

1. Raw materials and components,
2. Work in progress,
3. Finished goods,
4. Stock-in-trade (in respect of goods acquired for trading),
5. Stores and spares,
6. Loose tools, and
7. Others (specify nature).

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ILLUSTRATIONS

Illustration 1

The company deals in three products, A, B and C, which are neither similar nor interchangeable. At the time of closing of its account for the year 20X1-X2, the Historical Cost and Net Realisable Value of the items of closing stock are determined as follows:

Items	Historical Cost (Rs.in lakhs)	Net Realisable Value (Rs.in lakhs)
A	**40**	**28**
B	**32**	**32**
C	**16**	**24**

Solution

As per AS 2 (Revised) on 'Valuation of Inventories', inventories should be valued at the lower of cost and net realisable value. Inventories should be written down to net realisable value on an item-by-item basis in the given case.

Items	Historical Cost (Rs.in lakhs)	Net Realisable Value (Rs.in lakhs)	Valuation of closing stock (Rs.in lakhs)
A	40	28	28
B	32	32	32
C	16	24	16
	88	84	76

Hence, closing stock will be valued at Rs.76 lakhs.

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Illustration 2

X Co. Limited purchased goods at the cost of Rs.40 lakhs in October, 20X1. Till March, 20X2, 75% of the stocks were sold. The company wants to disclose closing stock at 10 lakhs. The expected sale value is Rs.11 lakhs and a commission at 10% on sale is payable to the agent. Advise, what is the correct closing stock to be disclosed as at 31.3.20X2.

Solution

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

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

Illustration 3

In a production process, normal waste is 5% of input. 5,000 MT of input were put in process resulting in wastage of 300 MT. Cost per MT of input is Rs.1,000. The entire quantity of waste is on stock at the year end. State with reference to Accounting Standard, how will you value the inventories in this case?

Solution

As per AS 2 (Revised), abnormal amounts of wasted materials, labour and other production costs are excluded from cost of inventories and such costs are recognised as expenses in the period in which they are incurred.

In this case, normal waste is 250 MT and abnormal waste is 50 MT. The cost of 250 MT will be included in determining the cost of inventories (finished goods) at the year end. The cost of abnormal waste (50 MT x 1,052.6315 = Rs.52,632) will be charged to the profit and loss statement.

Cost per MT (Normal Quantity of 4,750 MT) = 50,00,000 / 4,750 = Rs.1,052.6315

Total value of inventory = 4,700 MT x Rs.1,052.6315 = Rs.49,47,368.

Illustration 4

You are required to value the inventory per kg of finished goods consisting of:

	Rs. per kg.
Material cost	**200**
Direct labour	**40**
Direct variable overhead	**20**

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Fixed production charges for the year on normal working capacity of 2 lakh kgs is Rs.20 lakhs. 4,000 kgs of finished goods are in stock at the year end.

Solution

In accordance with AS 2 (Revised), the cost of conversion include a systematic allocation of fixed and variable overheads that are incurred in converting materials into finished goods. The allocation of fixed overheads for the purpose of their inclusion in the cost of conversion is based on normal capacity of the production facilities.

Cost per kg. of finished goods:

		Rs.
Material Cost		200
Direct Labour	40	
Direct Variable Production Overhead	20	
Fixed Production Overhead $\left(\frac{20,00,000}{2,00,000}\right)$	10	70
		270

Hence the value of 4,000 kgs. of finished goods = 4,000 kgs x Rs.270 = Rs.10,80,000

TEST YOUR KNOWLEDGE

MCQs

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

2. **Materials and other supplies held for use in the production of inventories are not written down below cost if the finished products in which they will be incorporated are expected to be**
   a. **sold at or above cost.**
   b. **sold above cost.**
   c. **sold less than cost.**
   d. **sold at market value (where market value is more than cost).**

3. **All of the following costs are excluded while computing value of inventories except?**
   a. **Selling and Distribution costs**
   b. **Allocated fixed production overheads based on normal capacity.**
   c. **Abnormal wastage**
   d. **Storage costs (which is necessary part of the production process)**

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4. **Identify the statement(s) which is/are incorrect.**
   a. **Storage costs which is a necessary part of the production process is included in inventory valuation.**
   b. **Administration overheads are never included in inventory valuation.**
   c. **Full amount of variable production overheads incurred are included in inventory valuation.**
   d. **Administration overheads are always included in inventory valuation.**

ANSWERS/SOLUTION

MCQs

1.	**b.**	Raw materials
2.	**a.**	sold at or above cost.
3.	**b.**	Allocated fixed production overheads based on normal capacity.
4.	**b.**	Administration overheads are never included in inventory valuation.

THEORY QUESTIONS

Q.NO.1. "In determining the cost of inventories, it is appropriate to exclude certain costs and recognise them as expenses in the period in which they are incurred". Provide examples of such costs as per AS 2 (Revised) 'Valuation of Inventories'.

ANSWER

As per AS 2 (Revised) 'Valuation of Inventories', certain costs are excluded from the cost of the inventories and are recognised as expenses in the period in which incurred. Examples of such costs are:

a. abnormal amount of wasted materials, labour, or other production costs;

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

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

d. selling and distribution costs.

PRACTICAL QUESTIONS

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Q.NO.1. Capital Cables Ltd., has a normal wastage of 4% in the production process. During the year 20X1-20X2 the Company used 12,000 MT of raw material costing Rs.150 per MT. At the end of the year 630 MT of wastage was in stock. The accountant wants to know how this wastage is to be treated in the books. Explain in the context of AS 2 (Revised) the treatment of normal loss and abnormal loss and also find out the amount of abnormal loss, if any.

SOLUTION

As per AS 2 (Revised) 'Valuation of Inventories', abnormal amounts of wasted materials, labour and other production costs are excluded from cost of inventories and such costs are recognised as expenses in the period in which they are incurred. The normal loss will be included in determining the cost of inventories (finished goods) at the year end.

Amount of Abnormal Loss:

Material used 12,000 MT @ Rs.150	= Rs.18,00,000
Normal Loss (4% of 12,000 MT)	480 MT
Net quantity of material	11,520 MT
Abnormal Loss in quantity	150 MT
Abnormal Loss	Rs.23,437.50

[150 units @ Rs.156.25 (Rs.18,00,000/11,520)]

Amount Rs.23,437.50 will be charged to the Statement of Profit and Loss.

Q.NO.2. Mr. Mehul gives the following information relating to items forming part of inventory as on 31-3-20X1. His factory produces Product X using Raw material A.

i. 600 units of Raw material A (purchased @ Rs.120). Replacement cost of raw material A as on 31-3-20X1 is Rs.90 per unit.

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

iii. 1500 units of finished Product X and total cost incurred Rs.320 per unit.

Expected selling price of Product X is Rs.300 per unit.

Determine how each item of inventory will be valued as on 31-3-20X1. Also calculate the value of total inventory as on 31-3-20X1.

<u>SOLUTION</u>

As per AS 2 (Revised) "Valuation of Inventories", materials and other supplies held for use in the production of inventories are not written down below cost if the finished products in which they will be incorporated are expected to be sold at cost or above cost. However, when there has been a decline in the price of materials and it is estimated that the cost of the finished products will exceed net realisable value, the materials are written down to net realisable value. In such circumstances, the replacement cost of the materials may be the best available measure of their net realisable value. In the given case, selling price of product X is Rs.300 and total cost per unit for production is Rs.320.

Hence the valuation will be done as under:

i. 600 units of raw material will be written down to replacement cost as market value of finished product is less than its cost, hence valued at Rs.90 per unit.

ii. 500 units of partly finished goods will be valued at 240 per unit i.e. lower of cost (Rs.260) or Net realisable value Rs.240 (Estimated selling price Rs.300 per unit less additional cost of Rs.60).

iii. 1,500 units of finished product X will be valued at NRV of Rs.300 per unit since it is lower than cost Rs.320 of product X.

Valuation of Total Inventory as on 31.03.20X1:

	Units	**Cost (Rs.)**	**NRV / Replacement cost**	**Value = units x cost or NRV whichever is less (Rs.)**
Raw material A	600	120	90	54,000
Partly finished goods	500	260	240	1,20,000

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Finished goods X	1,500	320	300	4,50,000
Value of Inventory				6,24,000

Q.NO.3. On 31st March 20X1, a business firm finds that cost of a partly finished unit on that date is Rs.530. The unit can be finished in 20X1-X2 by an additional expenditure of Rs.310. The finished unit can be sold for Rs.750 subject to payment of 4% brokerage on selling price. The firm seeks your advice regarding the amount at which the unfinished unit should be valued as at 31st March, 20X1 for preparation of final accounts. Assume that the partly finished unit cannot be sold in semi-finished form and its NRV is zero without processing it further.

SOLUTION

Valuation of unfinished unit

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

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UNIT 2: ACCOUNTING STANDARD 10: PROPERTY, PLANT AND EQUIPMENT

LEARNING OUTCOMES

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

- Definition of PPE
- What is the Recognition Criteria for PPE
  - Initial Costs
  - Subsequent Costs
- Measurement at Recognition
  - What is included in elements of Cost
  - Measurement of Cost
- Measurement after Recognition
  - Cost Model
  - Revaluation Model
- Depreciation
  - Depreciable Amount and Useful life
  - Depreciation Method
- Retirement in case of PPE
- Derecognition aspects
- Disclosure requirements.

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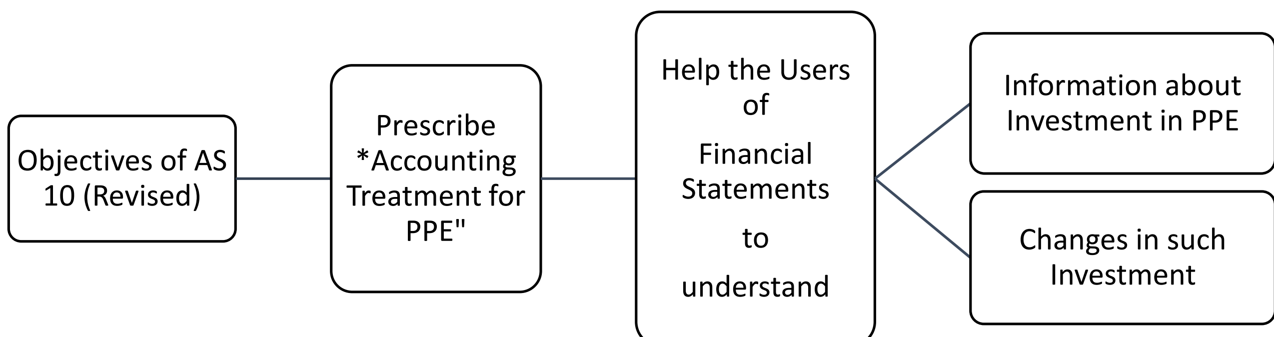
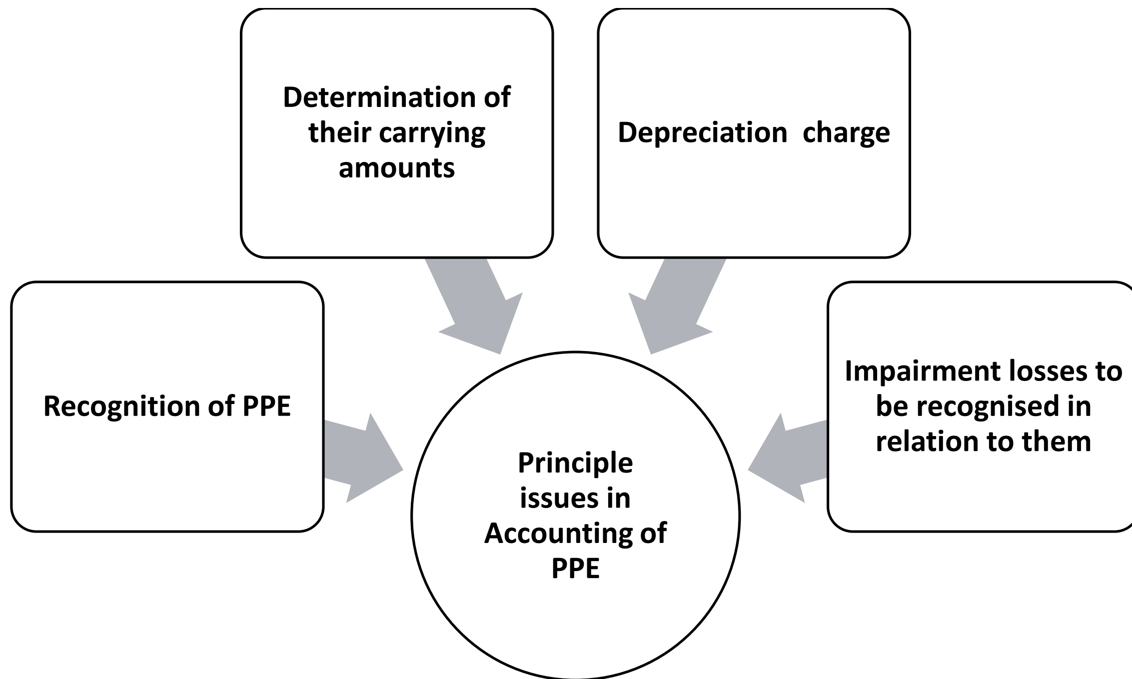
2.1 INTRODUCTION

The objective of this Standard is to prescribe accounting treatment for Property, Plant and Equipment (PPE).



The principal issues in Accounting for PPE are:



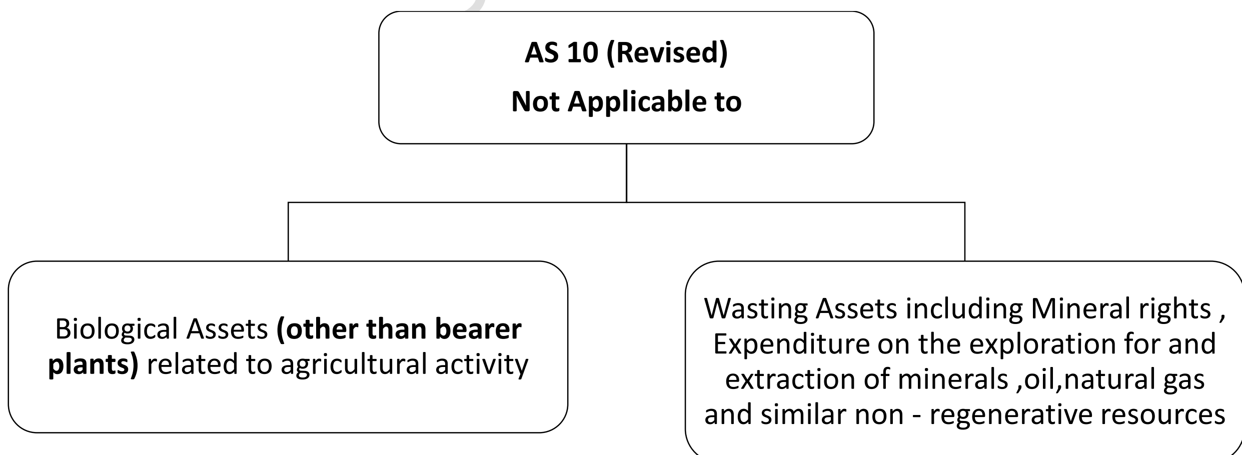
2.2 SCOPE OF THE STANDARD

As a general principle, AS 10 (Revised) should be applied in accounting for PPE.

Exception: When another Accounting Standard requires or permits a different accounting treatment.

Example:

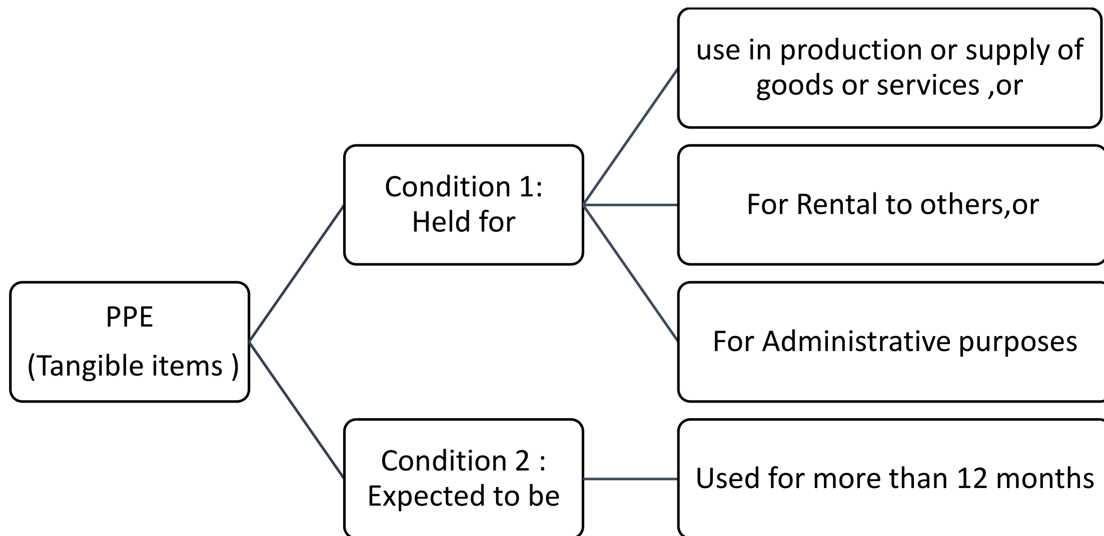
AS 19 on Leases, requires an enterprise to evaluate its recognition of an item of leased PPE on the basis of the transfer of risks and rewards. However, it may be noted that in such cases other aspects of the accounting treatment for these assets, including depreciation, are prescribed by this Standard.



Note: AS 10 (Revised) applies to Bearer Plants but it does not apply to the produce on Bearer Plants.

2.3 DEFINITION OF PROPERTY, PLANT AND EQUIPMENT (PPE)

There are 2 conditions to be satisfied for a TANGIBLE item to be called PPE. PPE are tangible items that:



Note: Intangible items are covered under AS 26.

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"Administrative purposes": The term 'Administrative purposes' has been used in wider sense to include <u>all business purposes</u>. Thus, PPE would include assets used for:

- Selling and distribution
- Finance and accounting
- Personnel and other functions of an Enterprise.

Items of PPE may also be acquired for safety or environmental reasons.

The acquisition of such PPE, although not directly increasing the future economic benefits of any particular existing item of PPE, may be necessary for an enterprise to obtain the future economic benefits from its other assets.

Such items of PPE qualify for recognition as assets because they enable an enterprise to derive future economic benefits from related assets in excess of what could be derived had those items not been acquired.

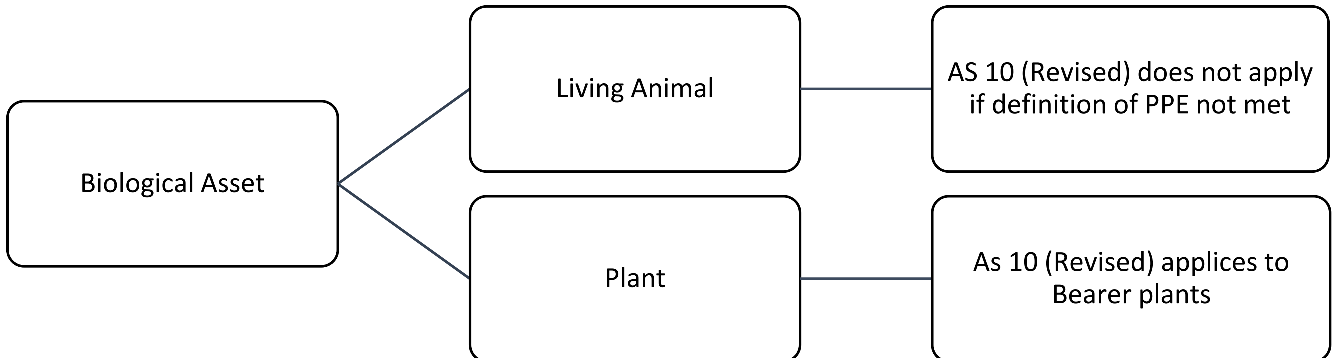
Example:

A chemical manufacturer may install new chemical handling processes to comply with environmental requirements for the production and storage of dangerous chemicals; related plant enhancements are recognised as an asset because without them the enterprise is unable to manufacture and sell chemicals.

The resulting carrying amount of such an asset and related assets is reviewed for impairment in accordance with AS 28 'Impairment of Assets'.

2.4 OTHER DEFINITIONS

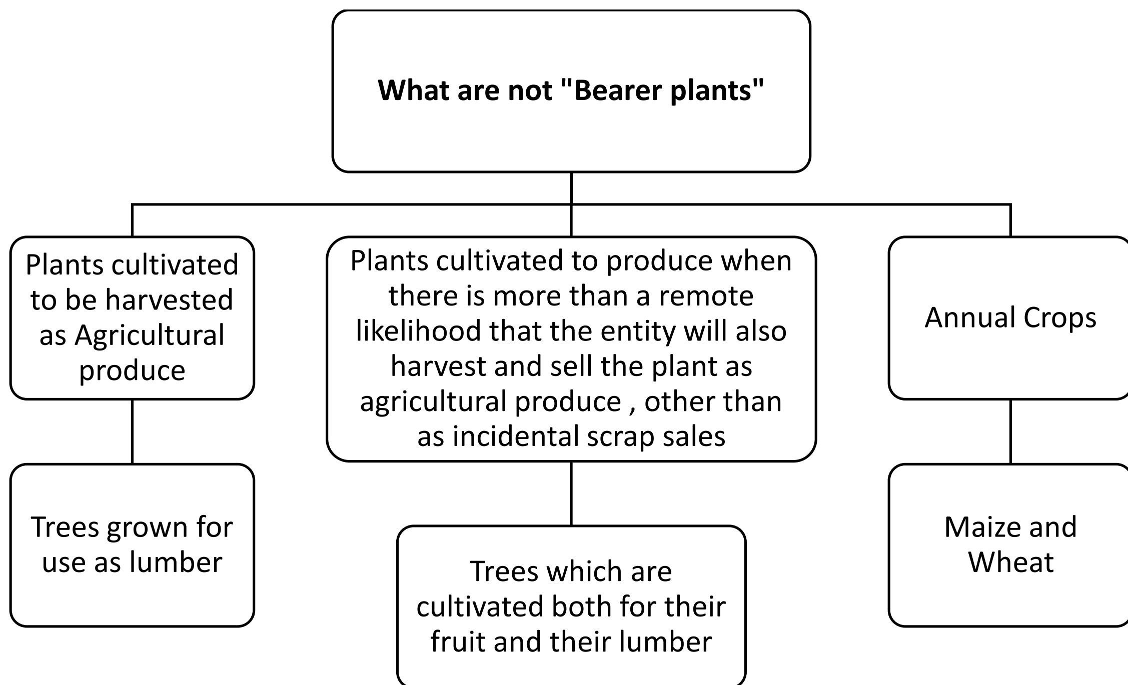
1. **Biological Asset**: An Accounting Standard on “Agriculture” is under formulation, which will, inter alia, cover accounting for livestock. Till the time, the Accounting Standard on “Agriculture” is issued, <u>accounting for livestock meeting the definition of PPE, will be covered as per AS 10</u> (Revised).



2. **Bearer Plant:** Is a plant that (satisfies all 3 conditions):

Condition	
Is used in the production or supply	• Of Agricultural procedure
Is expected to bear produce	• For more than a period of 12 months
Has a remote likelihood of being sold as Agricultural produce	• Except for incidental scrap sales

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



Agricultural Produce is the harvested product of Biological Assets of the enterprise.

3. **Agricultural Activity:** Is the management by an Enterprise of:
   - Biological transformation; and
   - Harvest of Biological Assets
     - For sale, Or
     - For conversion into Agricultural Produce, Or
     - Into additional Biological Assets

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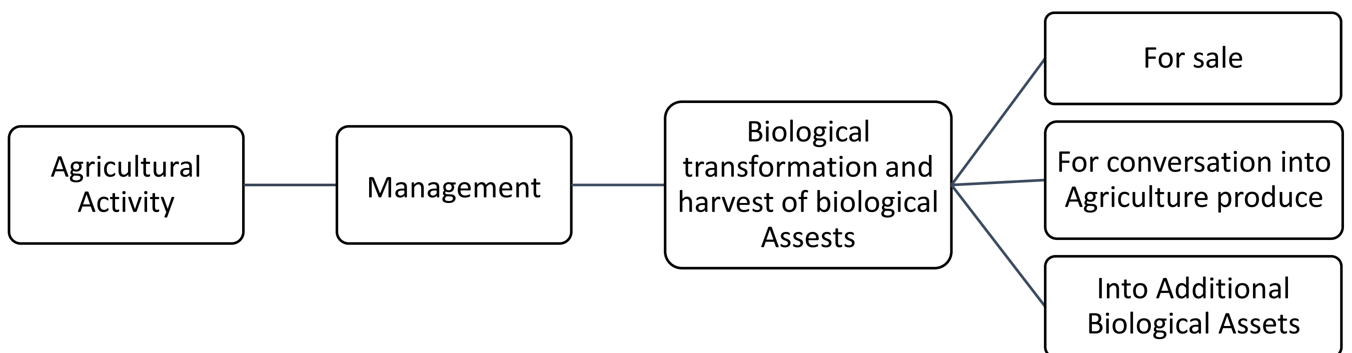


2.5 RECOGNITION CRITERIA FOR PPE

The cost of an item of PPE should be recognised as an asset if, and only if:

- It is probable that future economic benefits associated with the item will flow to the enterprise, and
- The cost of the item can be measured reliably.

Notes:

1. It may be appropriate to aggregate individually insignificant items, such as moulds, tools and dies and to apply the criteria to the aggregate value.
2. An enterprise may decide to expense an item which could otherwise have been included as PPE, because the amount of the expenditure is not material.

(Refer Illustration 1)

Treatment of Spare Parts, Stand by Equipment and Servicing Equipment

Case I If they meet the definition of PPE as per AS 10 (Revised):

- Recognised as PPE as per AS 10 (Revised)

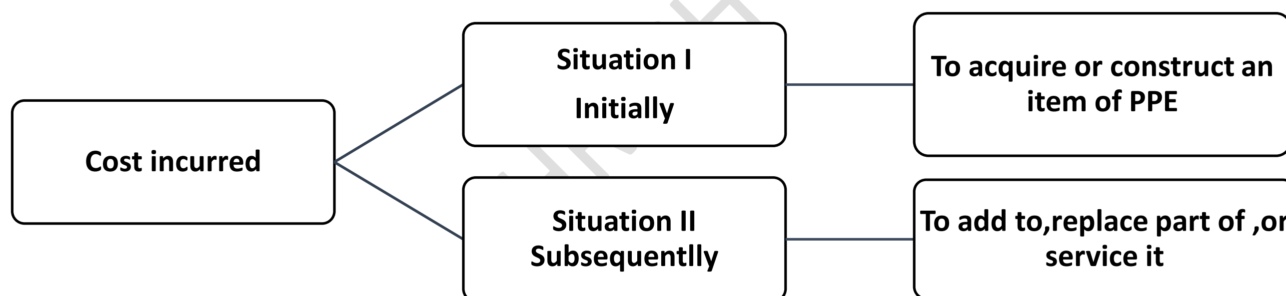
Case II If they do not meet the definition of PPE as per AS 10 (Revised):

- Such items are classified as Inventory as per AS 2 (Revised)

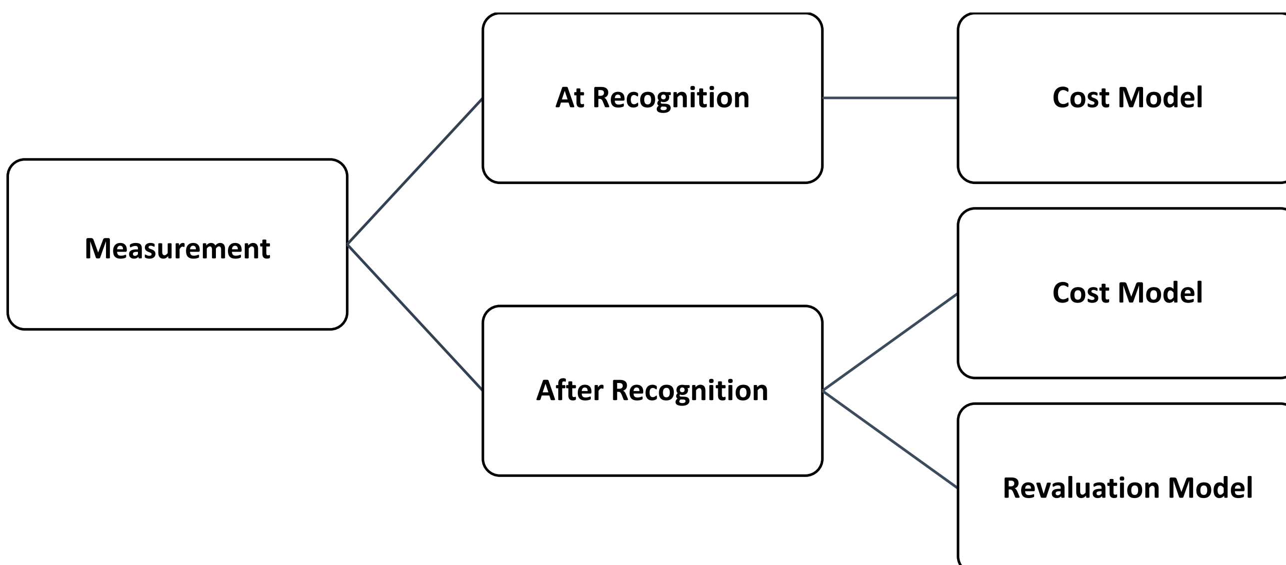
When do we apply the above criteria for Recognition?

An enterprise evaluates under this recognition principle all its costs on PPE at the time they are incurred.

These costs include costs incurred:



2.6 MEASUREMENT OF PPE

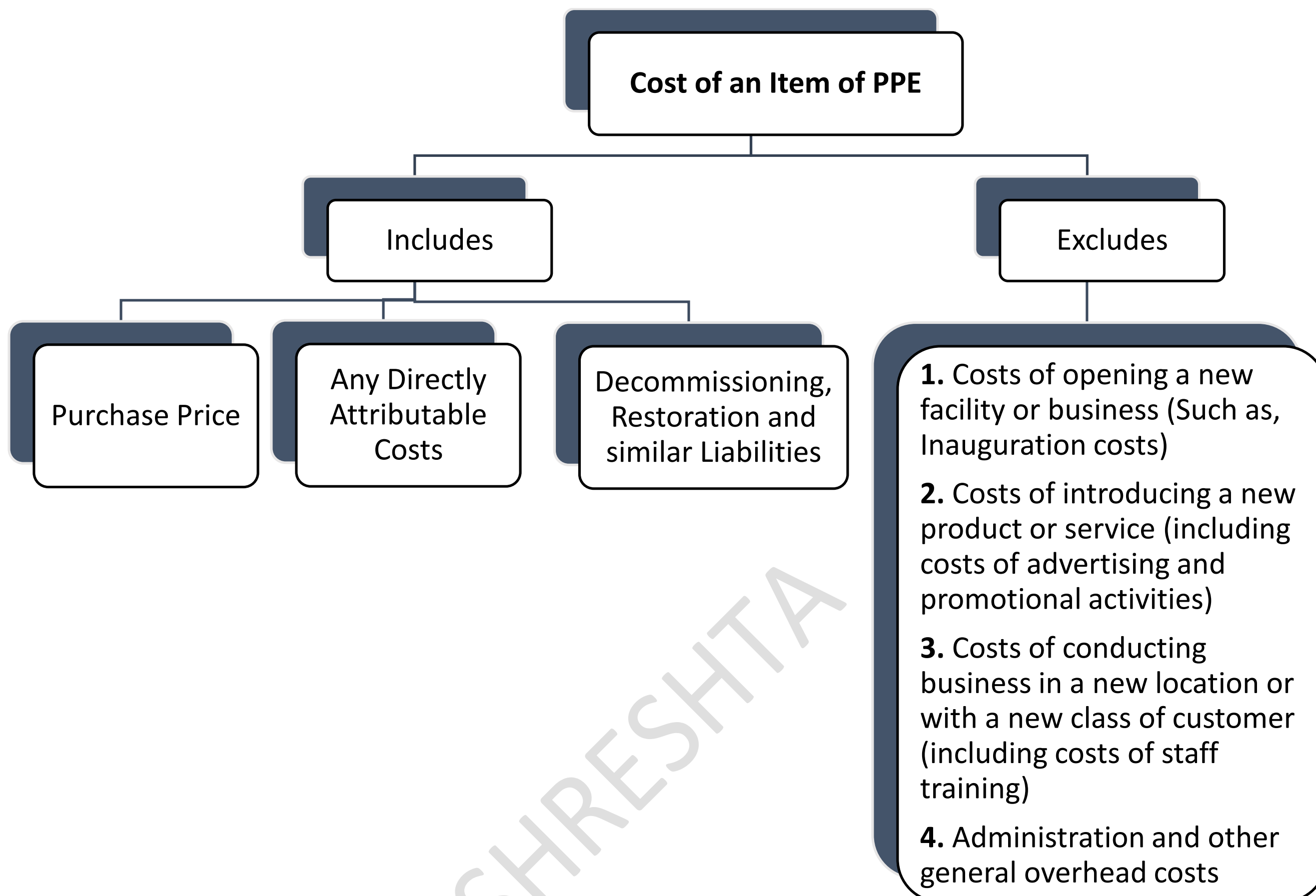


2.7 INITIAL RECOGNITION

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

What are the elements of Cost?

Cost of an item of PPE comprises:



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Let us understand the above in detail.

A. Purchase Price:

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

B. Directly Attributable Costs:

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

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

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

3. Costs of relocating or reorganising part or all of the operations of an enterprise.

Examples of directly attributable costs are:

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

Examples of costs that are not costs of an item of property, plant and equipment are:

a. Costs of opening a new facility or business, such as, inauguration costs
b. Costs of introducing a new product or service (including costs of advertising and promotional activities)
c. Costs of conducting business in a new location or with a new class of customer (including costs of staff training)
d. Administration and other general overhead costs

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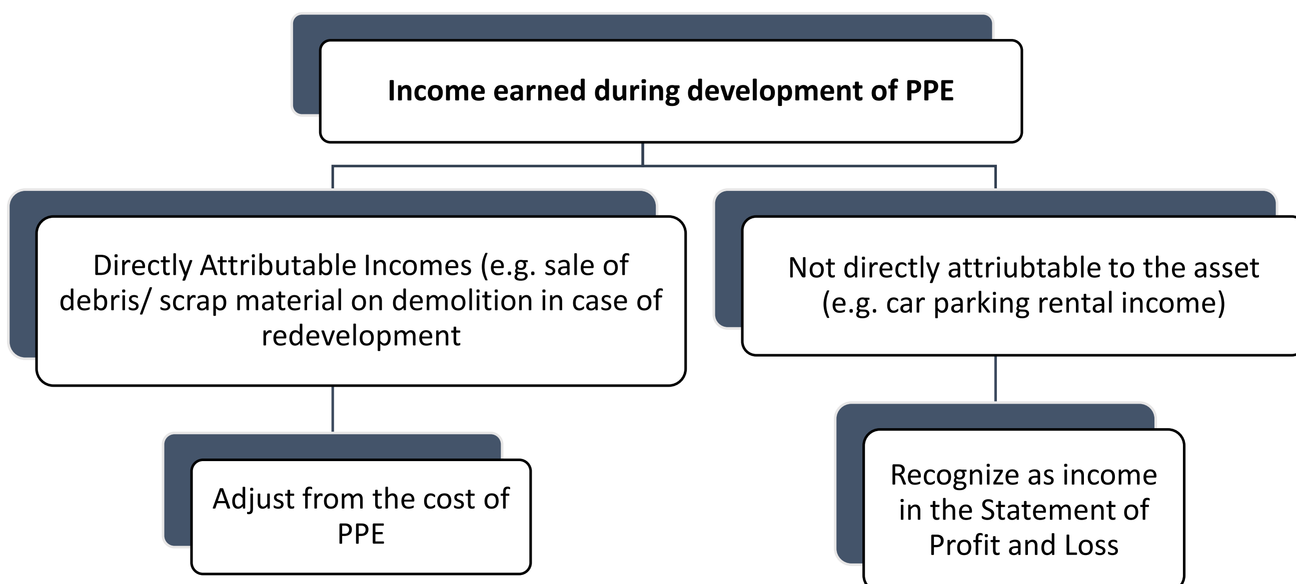
Note: Some operations occur in connection with the construction or development of an item of PPE but are not necessary to bring the item to the location and condition necessary for it to be capable of operating in the manner intended by management. These incidental operations may occur before or during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

Example:

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



(Refer Illustration 2 - 5)

C. Decommissioning, Restoration and similar Liabilities:

Initial estimate of the costs of dismantling, removing the item and restoring the site on which it is located, referred to as 'Decommissioning, Restoration and similar Liabilities', the obligation for which an enterprise incurs either when the item is acquired or as a consequence of having used the item during a particular period for purposes other than to produce inventories during that period. **Exception:** An enterprise applies AS 2 (Revised) "Valuation of Inventories", to the costs of obligations for dismantling, removing and restoring the site on which an item is located that are incurred during a particular period as a consequence of having used the item to produce inventories during that period.

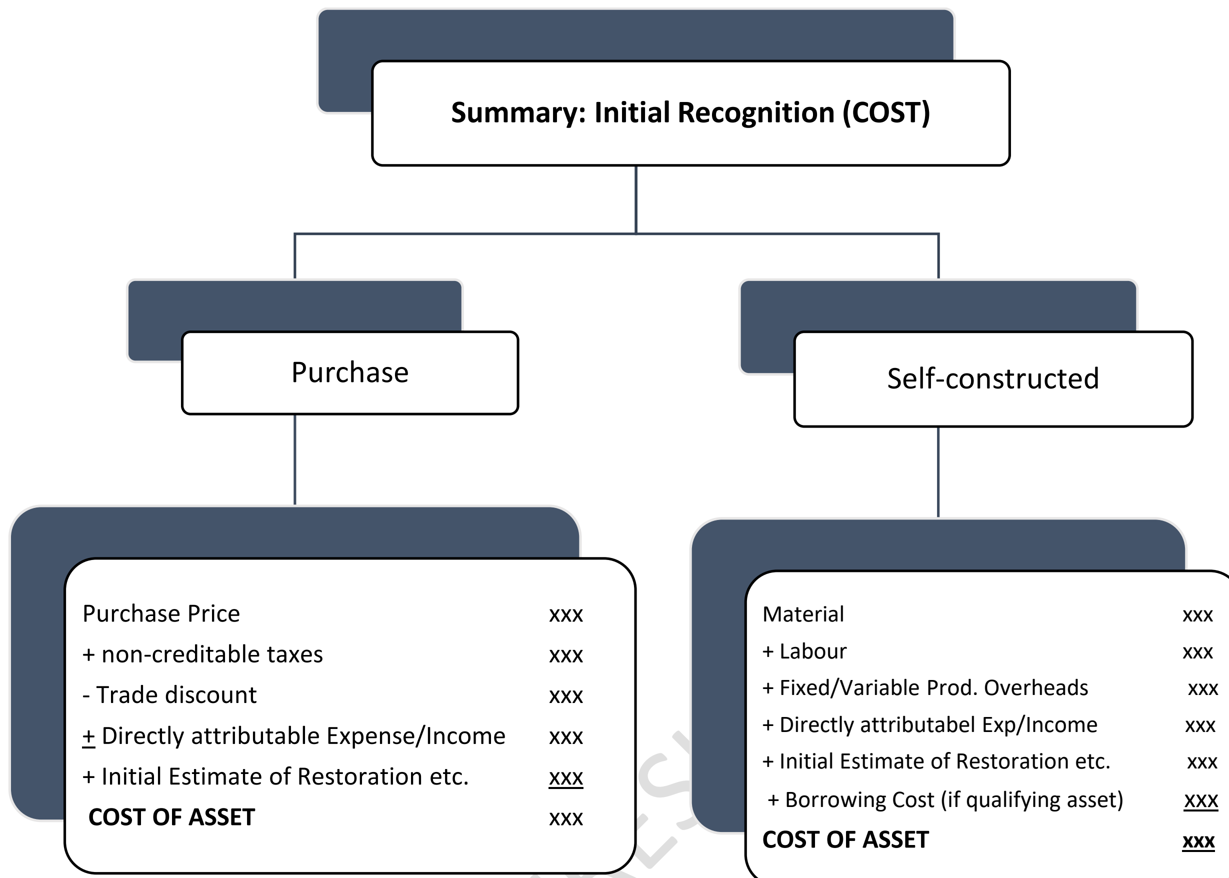
Note: The obligations for costs accounted for in accordance with AS 2 (Revised) or AS 10 (Revised) are recognised and measured in accordance with AS 29 (Revised) "Provisions, Contingent Liabilities and Contingent Assets".

2.8 COST OF A SELF-CONSTRUCTED ASSET

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

1. If an enterprise makes similar assets for sale in the normal course of business, the cost of the asset is usually the same as the cost of constructing an asset for sale (Refer AS 2). Therefore, any internal profits are eliminated in arriving at such costs.
2. Cost of abnormal amounts of wasted material, labour, or other resources incurred in self-constructing an asset is not included in the cost of the asset.
3. AS 16 on Borrowing Costs, establishes criteria for the recognition of interest as a component of the carrying amount of a self-constructed item of PPE.

4. Bearer plants are accounted for in the same way as self-constructed items of PPE before they are in the location and condition necessary to be capable of operating in the manner intended by management.



2.9 PPE ACQUIRED IN EXCHANGE FOR A NONMONETARY ASSET OR ASSETS OR A COMBINATION OF MONETARY AND NON-MONETARY ASSETS:

<u>Cost of such an item of PPE is measured at fair value unless:</u>

a. Exchange transaction lacks commercial substance; or

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

Note:

1. The acquired item(s) is/are measured in this manner even if an enterprise cannot immediately derecognise the asset given up.

2. The fair value of an asset is reliably measurable if (a) the variability in the range of reasonable fair value measurements is not significant for that asset or (b) the probabilities of the various estimates within the range can be reasonably assessed and used when measuring fair value. If an enterprise is able to measure reliably the fair value of either the asset received or the asset given up, then the fair value of the asset given up is used to measure the cost of the asset received unless the fair value of the asset received is more clearly evident.

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

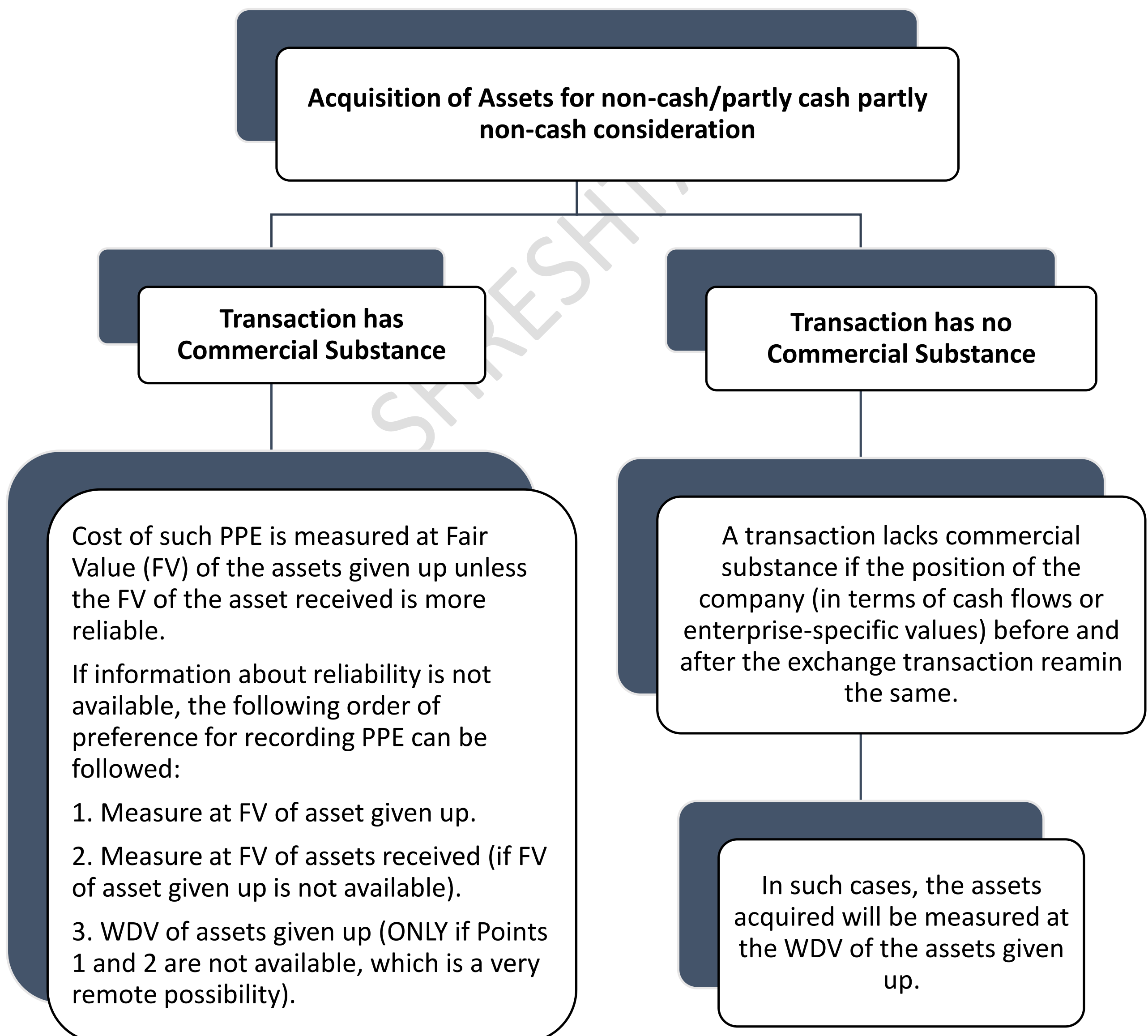
4. An enterprise determines whether an exchange transaction has commercial substance by considering the extent to which its future cash flows are expected to change as a result of the transaction. An exchange transaction has commercial substance if:

   a. the configuration (risk, timing and amount) of the cash flows of the asset received differs from the configuration of the cash flows of the asset transferred; or

   b. the enterprise-specific value of the portion of the operations of the enterprise affected by the transaction changes as a result of the exchange;

   c. and the difference in (a) or (b) is significant relative to the fair value of the assets exchanged.

   For the purpose of determining whether an exchange transaction has commercial substance, the enterprise-specific value of the portion of operations of the enterprise affected by the transaction should reflect post-tax cash flows. In certain cases, the result of these analyses may be clear without an enterprise having to perform detailed calculations



(Refer Illustration 6 & 7)

Determination of Cost in special cases:

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

A. If payment is deferred beyond normal credit terms:

Total payment minus Cash price equivalent

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

B. PPE purchased for a Consolidated Price:

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

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

C. PPE held by a lessee under a Finance Lease:

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

D. Government Grant related to PPE:

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

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2.10 TREATMENT OF SUBSEQUENT COSTS

Cost of day-to-day servicing

Meaning

Costs of day-to-day servicing are primarily the costs of labour and consumables and may include the cost of small parts. The purpose of such expenditures is often described as for the 'Repairs and Maintenance' of the item of PPE.

Accounting Treatment:

An enterprise does not recognise in the carrying amount of an item of PPE the costs of the day-to-day servicing of the item. Rather, these costs are recognised in the Statement of Profit and Loss as incurred.

Replacement of Parts of PPE

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

Examples

1. A furnace may require relining after a specified number of hours of use.
2. Aircraft interiors such as seats and galleys may require replacement several times during the life of the airframe.

3. Major parts of conveyor system, such as, conveyor belts, wire ropes, etc., may require replacement several times during the life of the conveyor system.
4. Replacing the interior walls of a building, or to make a non-recurring replacement.

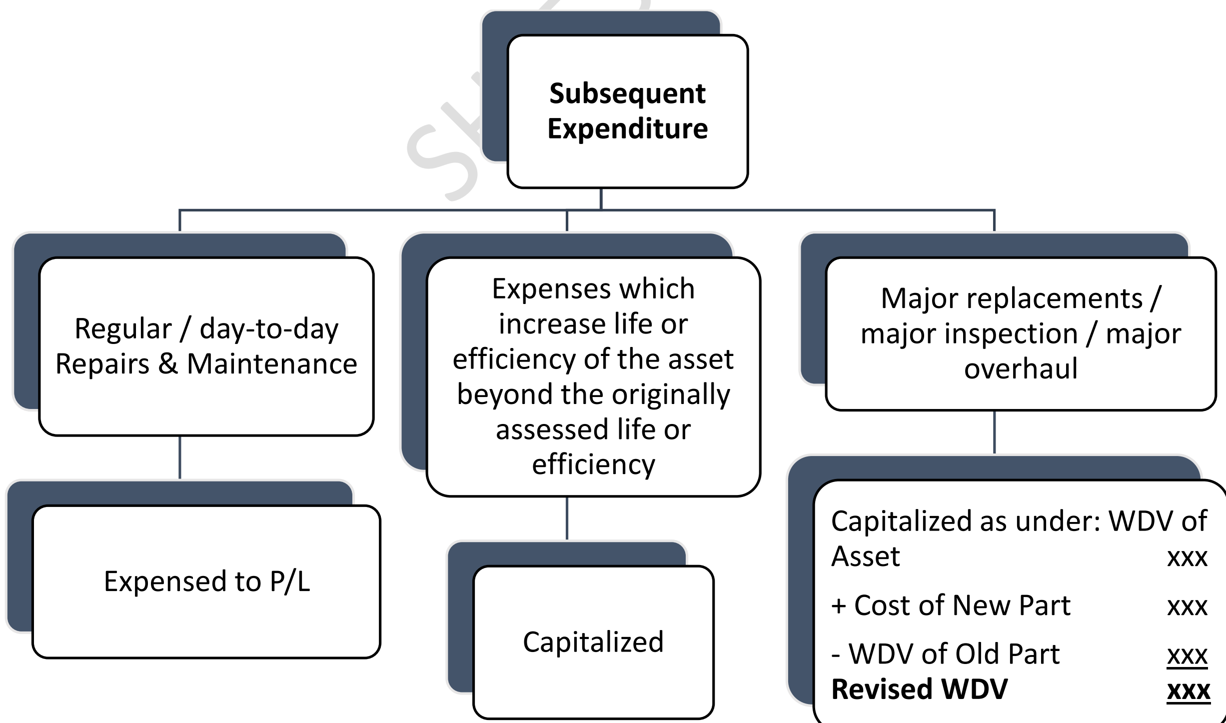
Accounting Treatment

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

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

Regular Major Inspections - Accounting Treatment

In certain cases, a condition of continuing to operate an item of property, plant and equipment (for example, an aircraft) may be performing regular major inspections for faults regardless of whether parts of the item are replaced. When each such major inspection is performed, its cost is recognised in the carrying amount of the item of PPE as a replacement, if the recognition criteria are satisfied. Any remaining carrying amount of the cost of the previous inspection (as distinct from physical parts) is derecognised.



The WDV of the old part / inspection (in case of major replacements / inspection) can be determined through the following sources (in order of preference):

i. Breakup from suppliers' invoice
ii. Fair value of the part / inspection at the time of purchase

If it is not practicable for an enterprise to determine the carrying amount of the replaced part/ inspection, it may use the cost of the replacement or the estimated cost of a future similar inspection as an indication of what the cost of the replaced part/ existing inspection component was when the item was acquired or constructed.

The WDV of the old part / inspection is computed after deducting the applicable depreciation.

(Refer Illustration 8 & 9)

MEASUREMENT AFTER RECOGNITION

An enterprise should choose

- Either Cost model,
- Or Revaluation model

as its accounting policy and should apply that policy to an entire **class of PPE.**

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

Examples of separate classes:

a. Land

b. Land and Buildings

c. Machinery

d. Ships

e. Aircraft

f. Motor Vehicles

g. Furniture and Fixtures

h. Office Equipment

i. Bearer plants

Cost Model

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

Cost- Any Accumulated Depreciation- Any Accumulated Impairment losses

Revaluation Model

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

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

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Revaluation for entire class of PPE

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

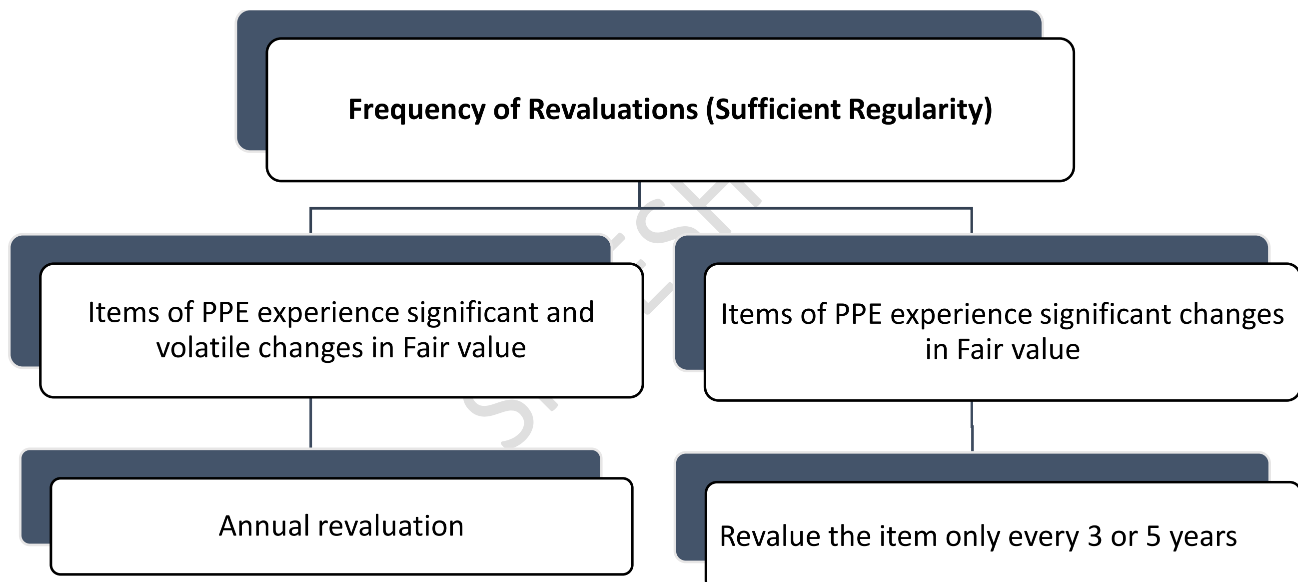
Reason

The items within a class of PPE are revalued simultaneously to avoid selective revaluation of assets and the reporting of amounts in the Financial Statements that are a mixture of costs and values as at different dates. It will ensure true and fair view of financial statements.

(Refer Illustration 10)

Frequency of Revaluations

Revaluations should be made with sufficient regularity to ensure that the carrying amount does not differ materially from that which would be determined using Fair value at the Balance Sheet date. The frequency of revaluations depends upon the changes in fair values of the items of PPE being revalued.



Determination of Fair Value

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

If there is no market-based evidence of fair value because of the specialised nature of the item of PPE and the item is rarely sold, except as part of a continuing business, an enterprise may need to estimate fair value using an income approach Based on (Discounted cash flow projections) Ora depreciated replacement cost approach which aims at making a **realistic estimate of the current cost** of acquiring or constructing an item that has the same service potential as the existing item.

Accounting Treatment of Revaluations

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

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

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

Gross carrying amount

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

Accumulated depreciation at the date of the revaluation is

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

Case Study on Technique I

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

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

Particulars	Cost/ Revalued Cost	Accumulated depreciation	Net book value
PPE before revaluation (assumed)	1,000	400	600
Fair Value			1,500
Revaluation Gain			900
Gain allocated proportionately to cost and depreciation	1,500 (900 x 1,000/600)	600 (900 x 400/600)	900
PPE after revaluation	2,500	1,000	1,500

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

The following journal entry will be passed:

PPE	Dr.	1,500	
To Accumulated Depreciation			600
To Gain on Revaluation*			900

* Accounting treatment discussed later

B. Technique 2: Accumulated depreciation Is eliminated against the Gross Carrying amount of the asset

Case Study on Technique II

(Taking the information given in the above Example)

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

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

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

The following journal entries will be passed:

Accumulated Depreciation Dr. 400

To PPE 400

(Accumulated depreciation eliminate against gross carrying amount of asset)

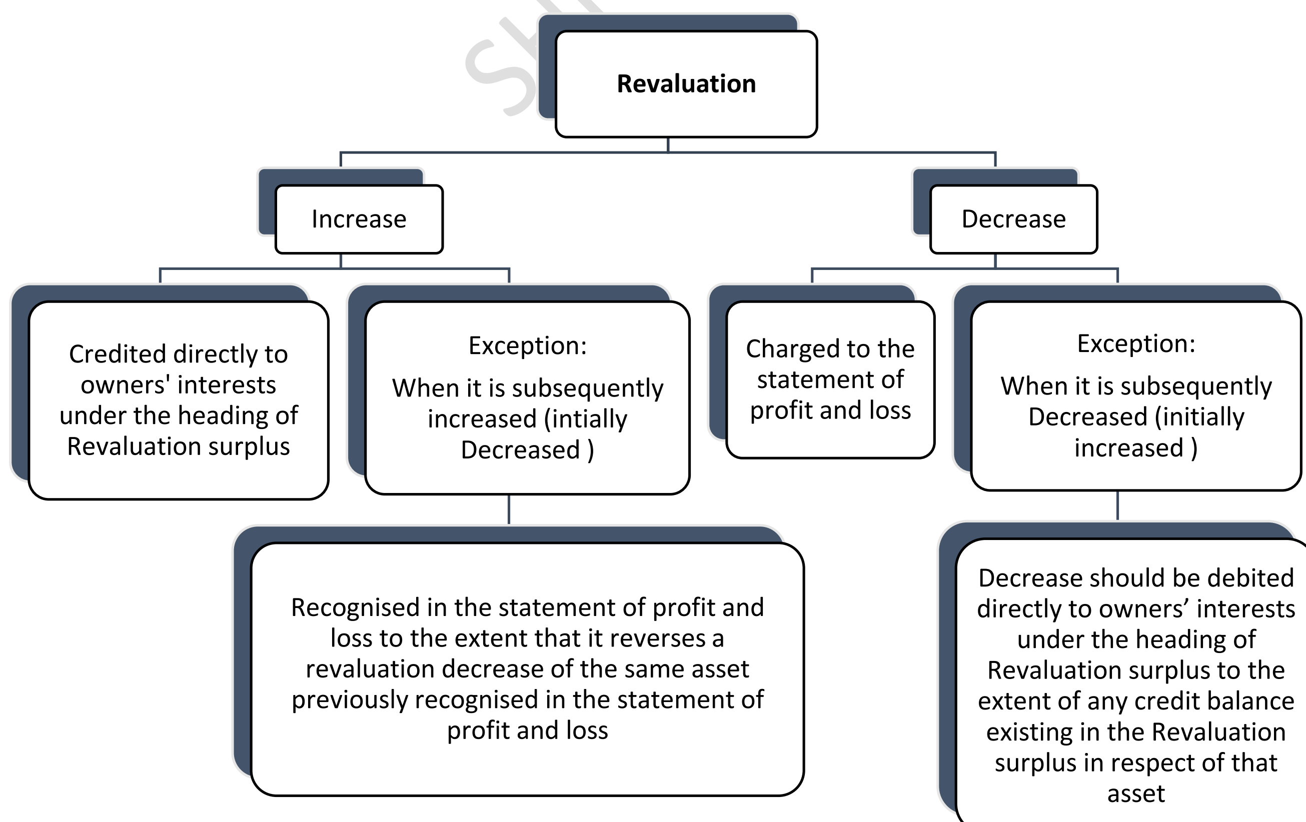
Therefore, carrying amount of asset is reduced to = 1,000 – 400 = 600

PPE Dr. 900

To Gain on Revaluation* 900

* Gain on Revaluation 1,500 – 600 = 900 recognized entirely in PPE, accounting treatment of this gain to be discussed later.

Revaluation – Increase or Decrease



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Treatment of Revaluation Surplus

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

Case I: When whole surplus is transferred:

When the asset is:

- Retired; Or
- Disposed of

Case II: Some of the surplus may be transferred as the asset is used by an enterprise:

In such a case, the amount of the surplus transferred would be:

Depreciation (based on Revalued Carrying amount) – Depreciation (based on Original Cost)

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

Depreciation

Component Method of Depreciation:

Each part of an item of PPE with a cost that is significant in relation to the total cost of the item should be depreciated separately. An enterprise allocates the amount initially recognised in respect of an item of PPE to its significant parts and depreciates each such part separately.

Example:

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

Is Grouping of Components possible?

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

Accounting Treatment

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

Examples on Exception

AS 2 (Revised): Depreciation of manufacturing plant and equipment is included in the costs of conversion of inventories as per AS 2 (Revised).

AS 26: Depreciation of PPE used for development activities may be included in the cost of an intangible asset recognised in accordance with AS 26 on Intangible Assets.

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Depreciable Amount and Depreciation Period

Depreciable amount is:

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

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

Useful life is:

a. the period over which an asset is **expected to be available** for use by an enterprise; or

b. the number of production or similar units expected to be obtained from the asset by an enterprise.

The residual value of an asset is the **estimated amount** that an enterprise would **currently obtain** from disposal of the asset, after deducting the estimated costs of disposal, if the asset were already of the age and in the condition expected at the end of its useful life.

All the following **factors** are considered **in determining the useful life** of an asset:

a. **expected usage** of the asset. Usage is assessed by reference to the expected capacity or physical output of the asset.

b. **expected physical wear and tear,** which depends on operational factors such as the number of shifts for which the asset is to be used and the repair and maintenance programme, and the care and maintenance of the asset while idle.

c. **technical or commercial obsolescence** arising from changes or improvements in production, or from a change in the market demand for the product or service output of the asset.

Expected future reductions in the selling price of an item that was produced using an asset could indicate the expectation of technical or commercial obsolescence of the asset, which, in turn, might reflect a reduction of the future economic benefits embodied in the asset.

d. **legal or similar limits** on the use of the asset, such as the expiry dates of related leases.

(Refer Illustration 11)

Review of Residual Value and Useful Life of an Asset

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

Example:

As per accounting policy of NS Limited, engaged in shipping business, residual value of Steel containers is 5%. Based on the external factors, steel prices have increased in recent past and based on the recent data, company has observed that realized scrap value is approximately 10% of the cost of the container. The company does not anticipate any material movement in the steel price in the foreseeable future.

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In the above case, based on the yearly review of residual value of Steel containers, company should revise the residual value to 10%. The above change shall be treated as change in accounting estimate as per AS 5 and should be applied prospectively.

(Refer Illustration 12)

Commencement of period for charging Depreciation

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

(Refer Illustration 13)

Cessation of Depreciation

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

The residual value of an asset may increase to an amount equal to or greater than its carrying amount. If it does, depreciation charge of the asset is zero unless and until its residual value subsequently decreases to an amount below its carrying amount.

(Refer Illustration14)

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

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

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

However, under usage methods of depreciation, the depreciation charge can be zero while there is no production.

Land and Buildings

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

A. Land: Land has an unlimited useful life and therefore is not depreciated.

Exceptions: Quarries and sites used for landfill.

Depreciation on Land:

i. If land itself has a limited useful life:

It is depreciated in a manner that reflects the benefits to be derived from it.

ii. If the cost of land includes the costs of site dismantlement, removal and restoration:

That portion of the land asset is depreciated over the period of benefits obtained by incurring those costs.

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B. Buildings:

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

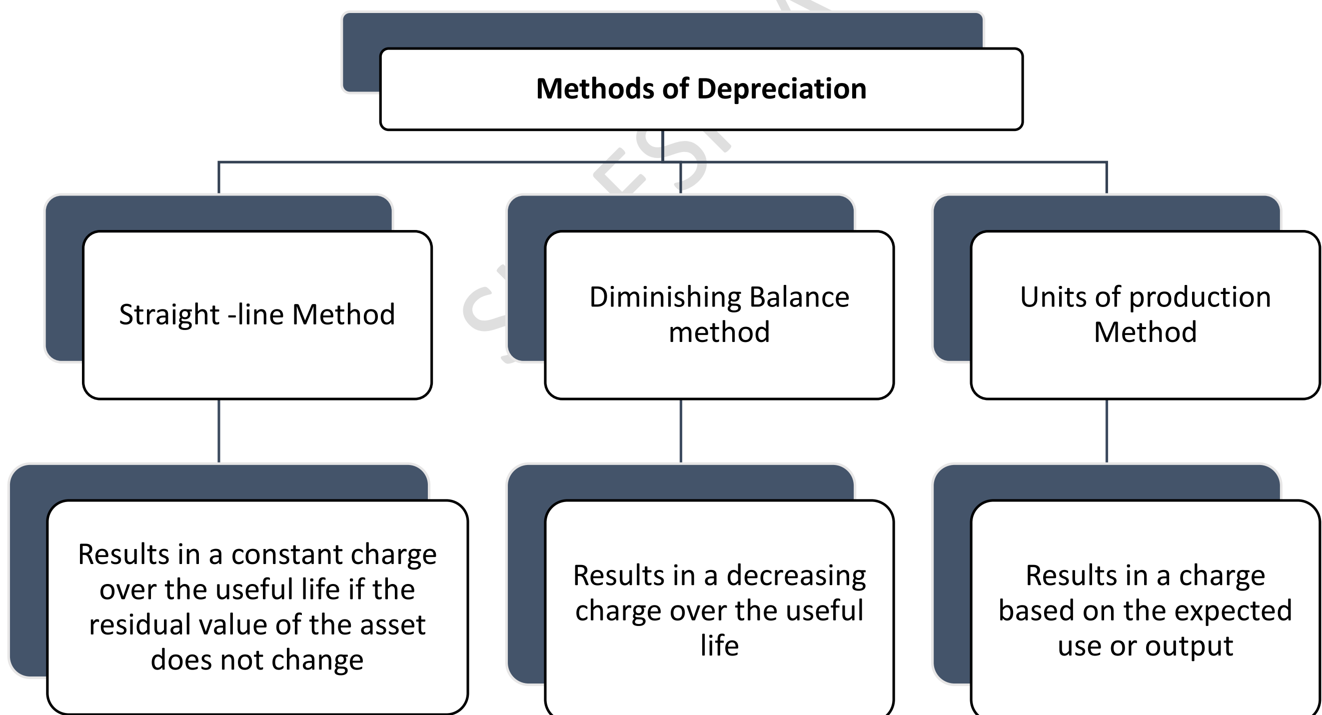
An increase in the value of the land on which a building stands does not affect the determination of the depreciable amount of the building.

Depreciation Method

The enterprise selects the method that most closely reflects the expected pattern of consumption of the future economic benefits embodied in the asset. The depreciation method used should reflect the pattern in which the future economic benefits of the asset are expected to be consumed by the enterprise.

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

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



Review of Depreciation Method

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

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

Depreciation Method based on Revenue

A depreciation method that is based on revenue that is generated by an activity that includes the use of an asset is not appropriate. Because the price component of revenue may be affected by inflation, which has no bearing upon the way in which an asset is consumed.

(Refer Illustration 15)

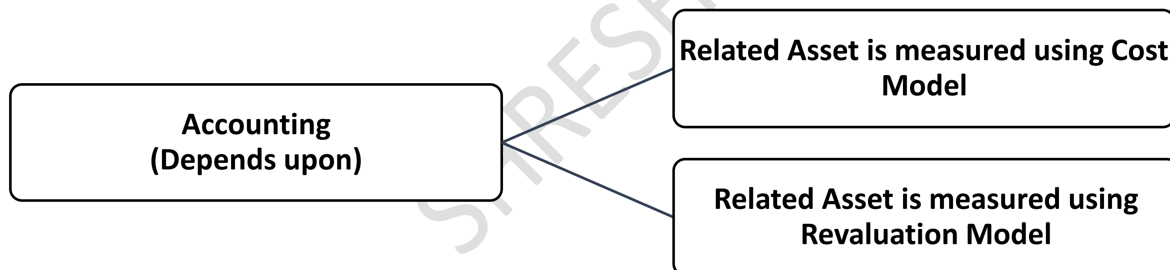
Changes in Existing Decommissioning, Restoration and other Liabilities

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

- Changes in Liabilities
- Price Adjustments
- Changes in Duties
- Changes in initial estimates of amounts provided for Dismantling, Removing, Restoration, and
- Similar factors

The above are included in the cost of the asset.

Accounting for the above changes:



A. If the related asset is measured using the Cost model

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

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

If the adjustment results in an addition to the cost of an asset

- Enterprise should consider whether this is an indication that the new carrying amount of the asset may not be fully recoverable.

> **Note:** If it is such an indication, the enterprise should test the asset for impairment by estimating its recoverable amount, and should account for any impairment loss, in accordance with applicable Accounting standards.

B. If the related asset is measured using the Revaluation model:

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

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

Exception

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

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

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

Exception

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

Caution

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

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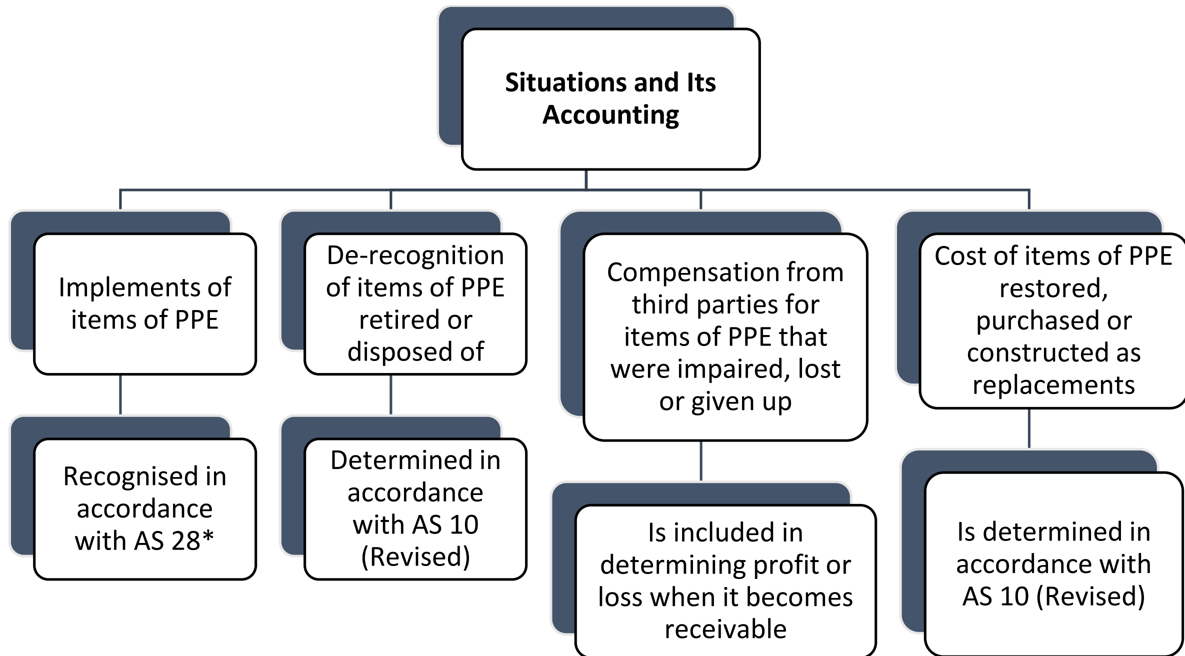
The adjusted depreciable amount of the asset is depreciated over its useful life.

What happens if the related asset has reached the end of its useful life?

All subsequent changes in the liability should be recognised in the Statement of Profit and Loss as they occur.

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

Accounting for Compensation for Impairment:



(Refer Illustration 16)

Retirements

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

- Carrying Amount, and
- Net Realisable Value

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

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De-recognition

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

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

Accounting Treatment

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

Where,

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

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

Note: Gains should not be classified as revenue, as defined in AS 9 'Revenue Recognition'. The consideration receivable on disposal of an item of property, plant and equipment is recognised in accordance with the principles enunciated in AS 9.

Exception

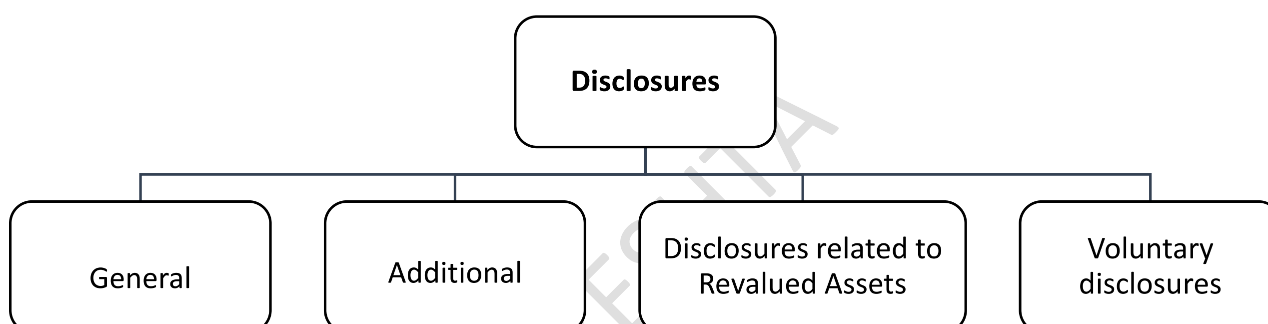
An enterprise that in the course of its ordinary activities, routinely sells items of PPE that it had held for rental to others should transfer such assets to inventories at their carrying amount when they cease to be rented and become held for sale.

The proceeds from the sale of such assets should be recognised in revenue in accordance with AS 9 on Revenue Recognition.

Determining the date of disposal of an item

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

Disclosure



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General Disclosures

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

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

b. The depreciation methods used;

c. The useful lives or the depreciation rates used.

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

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

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

i. Additions

ii. assets retired from active use and held for disposal

iii. acquisitions through business combinations

iv. increases or decreases resulting from revaluations and from impairment losses recognised or reversed directly in revaluation surplus in accordance with AS 2 28
v. impairment losses recognised in the statement of profit and loss in accordance with AS 28
vi. impairment losses reversed in the statement of profit and loss in accordance with AS 28
vii. depreciation
viii. net exchange differences arising on the translation of the financial statements of a non-integral foreign operation in accordance with AS 11
ix. other changes

Additional Disclosures

The financial statements should also disclose:

a. The existence and amounts of restrictions on title, and property, plant and equipment pledged as security for liabilities;
b. The amount of expenditure recognised in the carrying amount of an item of property, plant and equipment in the course of its construction;
c. The amount of contractual commitments for the acquisition of property, plant and equipment;
d. If it is not disclosed separately on the face of the statement of profit and loss, the amount of compensation from third parties for items of property, plant and equipment that were impaired, lost or given up that is included in the statement of profit and loss; and
e. The amount of assets retired from active use and held for disposal.

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Disclosures related to Revalued Assets

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

a. The effective date of the revaluation;
b. Whether an independent valuer was involved;
c. The methods and significant assumptions applied in estimating fair values of the items;
d. The extent to which fair values of the items were determined directly by reference to observable prices in an active market or recent market transactions on arm's length terms or were estimated using other valuation techniques; and
e. The revaluation surplus, indicating the change for the period and any restrictions on the distribution of the balance to shareholders.
f. Disclosure of the methods adopted and the estimated useful lives or depreciation rates.
g. Disclosures as per AS 5, applicable if any.
h. Information on impaired PPE.

Voluntary disclosures:

An enterprise is encouraged to disclose the following:

a. the carrying amount of temporarily idle property, plant and equipment;

b. the gross carrying amount of any fully depreciated property, plant and equipment that is still in use;

c. for each revalued class of property, plant and equipment, the carrying amount that would have been recognised had the assets been carried under the cost model;

d. the carrying amount of property, plant and equipment retired from active use and not held for disposal.

Reference: The students are advised to refer the full text of AS 10 (Revised) "Property, Plant and Equipment" (2016).

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ILLUSTRATIONS

<u>Illustration 1</u> (Capitalising the cost of "Remodelling" a Supermarket)

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

<u>Solution</u>

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

<u>Illustration 2</u>

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

1. **Setup costs of Rs.5,00,000 to install machinery in the new location.**
2. **Rent of Rs.15,00,000**
3. **Removal costs of Rs.3,00,000 to transport the machinery from the old location to the temporary location.**

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

<u>Solution</u>

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

<u>Illustration 3</u>

Omega Ltd. contracted with a supplier to purchase machinery which is to be installed in its one department in three months' time. Special foundations were required for the machinery which were to be prepared within this supply lead time. The cost of the site preparation and laying

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foundations were Rs.1,40,000. These activities were supervised by a technician during the entire period, who is employed for this purpose of Rs.45,000 per month. The machine was purchased at Rs.1,58,00,000 and Rs.50,000 transportation charges were incurred to bring the machine to the factory site. An Architect was appointed at a fee of Rs.30,000 to supervise machinery installation at the factory site. You are required to ascertain the amount at which the Machinery should be capitalized.

Solution

Particulars		Rs.
Purchase Price	Given	1,58,00,000
Add: Site Preparation Cost	Given	1,40,000
Technician's Salary	Specific / Attributable overheads for 3 months (45,000 x 3)	1,35,000
Initial Delivery Cost	Transportation	50,000
Professional Fees for Installation	Architect's Fees	30,000
Total Cost of Machinery		1,61,55,000

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Illustration 4 (Capitalisation of directly attributable costs)

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

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

Solution

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

However, if the cost of salaries, utilities and storage of goods are in the nature of operating expenditure that would be incurred if the supermarket was open, then these costs are not necessary to bring the store to the condition necessary for it to be capable of operating in the manner intended by management and should be expensed.

Illustration 5 (Operating costs incurred in the start-up period)

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

Solution

The net operating costs should not be capitalised but should be recognised in the Statement of Profit and Loss. Even though it is running at less than full operating capacity (in this case 80% of operating capacity), there is sufficient evidence that the amusement park is capable of operating in the manner intended by management. Therefore, these costs are specific to the start-up and, therefore, should be expensed as incurred.

Illustration 6 (Consideration received comprising a combination of non-monetary and monetary assets)

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

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Solution

In the given case, Plant & Machinery is valued at Rs.25,00,000, which is assumed to be fair value in absence of information. Further, since fair value of land (asset given up) is not given, the transaction will be recorded at fair value of assets acquired of Rs.45,00,000 (Rs. Cash 20,00,000 + Rs. Plant & Machinery 25,00,000). Since land of book value Rs.10,00,000 is transferred in exchange of assets worth Rs.45,00,000, a gain of Rs.35,00,000 will be recognised in the books of Entity A.

The following journal entry will be passed in the books of Entity A:

	Dr.	Cr.
Cash/ Bank A/c	Dr. 20,00,000	
Plant & Machinery A/c	Dr. 25,00,000	
To Land		10,00,000
To Profit on Sale of Land (balancing figure)		35,00,000

Illustration 7 (Exchange of assets that lack commercial substance)

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

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

Solution

Since the transaction lacks commercial substance, the entity recognises the assets received at the book value of car X. Therefore, it recognises cash of Rs.15,000 and car Y as PPE with a carrying value of Rs.12,85,000.

The following journal entry will be passed in the books of Entity A:

	Dr.	Cr.
Cash/ Bank A/c	Dr. 15,000	
Car Y A/c (balancing figure)	Dr. 12,85,000	
To Car X A/c		13,00,000

Illustration 8

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

Solution

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

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Illustration 9

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

Solution

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

Illustration 10 (Revaluation on a class by class basis)

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

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

Solution

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

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

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

Illustration 11

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

Solution

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

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

Illustration 12 (Change in estimate of useful life)

Entity A purchased an asset on 1st January 20X1 for Rs.1,00,000 and the asset had an estimated useful life of 10 years and a residual value of nil.

On 1st January 20X5, the directors review the estimated life and decide that the asset will probably be useful for a further 4 years.

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

Solution

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

On 1st January 20X5, the asset's net book value is [1,00,000 – (10,000 x 4)] Rs.60,000.

The remaining useful life is 4 years.

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

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

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

Illustration 13

Entity B constructs a machine for its own use. Construction is completed on 1st November 20X1 but the company does not begin using the machine until 1st March 20X2. Comment.

Solution

The entity should begin charging depreciation from the date the machine is ready for use – that is, 1st November 20X1. The fact that the machine was not used for a period after it was ready to be used is not relevant in considering when to begin charging depreciation.

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Illustration 14 (Depreciation where residual value is the same as or close to Original cost)

A property costing Rs.10,00,000 is bought in 20X1. Its estimated total physical life is 50 years. However, the company considers it likely that it will sell the property after 20 years.

The estimated residual value in 20 years' time, based on 20X1 prices, is:

Case (a) Rs.10,00,000

Case (b) Rs.9,00,000.

Calculate the amount of depreciation.

Solution

Case (a)

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

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

Case (b)

The company considers that the residual value, based on prices prevailing at the balance sheet date, will be Rs.9,00,000 and the depreciable amount is, therefore, Rs.1,00,000.

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

Illustration 15 (Determination of appropriate Depreciation Method)

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

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

Solution

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

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

Illustration 16 (Gain on replacement of Insured Assets)

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

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Solution

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

TEST YOUR KNOWLEDGE

MCQs

1. **As per AS 10 (Revised) 'Property, plant and equipment', which of the following costs is not included in the carrying amount of an item of PPE**
   a. **Costs of site preparation**
   b. **Costs of relocating**
   c. **Installation and assembly costs.**
   d. **initial delivery and handling costs**

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

3. **A plot of land with carrying amount of Rs.1,00,000 was revalued to Rs.1,50,000 at the end of Year 2. Subsequently, due to drop in market values, the land was determined to have a fair value of Rs.1,30,000 at the end of Year 4. Assuming that the entity adopts Revaluation Model, what would be the accounting treatment of Revaluation?**
   a. **Initial upward valuation of Rs.50,000 credited to Revaluation Reserve. Subsequent downward revaluation of Rs.20,000 debited to P/L.**
   b. **Initial upward valuation of Rs.50,000 credited to P/L. Subsequent downward revaluation of Rs.20,000 debited to P/L.**
   c. **Initial upward valuation of Rs.50,000 credited to Revaluation Reserve. Subsequent downward revaluation of Rs.20,000 debited to Revaluation Reserve.**
   d. **Initial upward valuation of Rs.50,000 debited to P/L. Subsequent downward revaluation of Rs.20,000 credited to P/L.**

4. **A plot of land with carrying amount of Rs.1,00,000 was revalued to Rs.90,000 at the end of Year 2. Subsequently, due to increase in market values, the land was determined to have a fair value of Rs.1,05,000 at the end of Year 4. Assuming that the entity adopts Revaluation Model, what would be the accounting treatment of Revaluation?**

SHRESHTA

a. **Initial downward valuation of Rs.10,000 debited to Revaluation Reserve. Subsequent upward revaluation of Rs.15,000 credited to P/L.**
b. **Initial downward valuation of Rs.10,000 debited to P/L. Subsequent upward revaluation of Rs.15,000 credited to P/L.**
c. **Initial downward valuation of Rs.10,000 debited to P/L. Subsequent upward revaluation of Rs.10,000 credited to P/L and Rs.5,000 credited to Revaluation Reserve.**
d. **Initial downward valuation of Rs.10,000 credited to P/L. Subsequent upward revaluation of Rs.10,000 debited to P/L and Rs.5,000 debited to Revaluation Reserve.**

5. **On sale of an asset which was revalued upwards, what would be the treatment of Revaluation Reserve?**
   a. **The Revaluation Reserve is credited to P/L since the profit on sale of such asset is now realized.**
   b. **The Revaluation Reserve is credited to Retained Earnings as a movement in reserves without impacting the P/L.**
   c. **No change in Revaluation Reserve since profit on sale of such asset is already impacting the P/L.**
   d. **The Revaluation Reserve is reduced from the asset value to compute profit or loss.**

SHRESHTA

6. **A machinery was purchased having an invoice price Rs.1,18,000 (including GST Rs.18,000) on 1 April 20X1. The GST amount is available as input tax credit. The rate of depreciation is 10% on SLM basis. The depreciation for 20X2-X3 would be**
   a. **Rs.10,000.**
   b. **Rs.11,800.**
   c. **Rs.9,000.**
   d. **Rs.10,500.**

ANSWERS/SOLUTIONS

MCQs

1.	**b.**	Costs of relocating
2.	**c.**	under cost model
3.	**c.**	Initial upward valuation of Rs.50,000 credited to Revaluation Reserve. Subsequent downward revaluation of Rs.20,000 debited to Revaluation Reserve.

4.	c.	Initial downward valuation of Rs.10,000 debited to P/L. Subsequent upward revaluation of Rs.10,000 credited to P/L and Rs.5,000 credited to Revaluation Reserve.
5.	b.	The Revaluation Reserve is credited to Retained Earnings as a movement in reserves without impacting the P/L.
6.	a.	Rs.10,000.

THEORY QUESTIONS

Q.NO.1. A company changed its method of depreciation from SLM to WDV. How should the change be recognised?

ANSWER

As per AS 10, Property, Plant and Equipment, the depreciation method applied to an asset should be reviewed at least at each financial year-end and, if there has been a significant change in the expected pattern of consumption of the future economic benefits embodied in the asset, the method should be changed to reflect the changed pattern. Such a change should be accounted for as a change in an accounting estimate in accordance with AS 5.

Accordingly, the change in method of depreciation should be accounting for as a change in accounting estimate, prospectively.

SHRESHTA

Q.NO.2. A company has debited the Building Account with the Cost of the Land on which the building stands and has provided depreciation on such total cost. Comment on the accounting treatment.

ANSWER

As per AS 10, Property, Plant and Equipment, each part of an item of property, plant and equipment with a cost that is significant in relation to the total cost of the item should be depreciated separately. Further, Land and buildings are separable assets and are accounted for separately, even when they are acquired together. With some exceptions, such as quarries and sites used for landfill, land has an unlimited useful life and therefore is not depreciated. Buildings have a limited useful life and therefore are depreciable assets.

In the given case, land should not be depreciated unless it has a limited useful life. Accordingly, it is incorrect to debit the cost of land to the Building Account and provide depreciation on the aggregate cost.

Q.NO.3. An entity is setting up a manufacturing plant. Construction of the plant is completed in August and the plant is ready for commercial production in November. However, the entity commences production in March. When should be company start charging depreciation.

ANSWER

As per AS 10, Property, Plant and Equipment, depreciation of an asset begins when it is available for use, i.e., when it is in the location and condition necessary for it to be capable of operating in the manner intended by management.

In the given case, since the plant is ready for commercial production in November, depreciation shall commence from November. The date of commencement of commercial production is irrelevant for charging depreciation.

Q.NO.4. Which factors should be considered by a company while determining useful life?

ANSWER

All the following factors are considered in determining the useful life of an asset:

a. expected usage of the asset. Usage is assessed by reference to the expected capacity or physical output of the asset.

b. expected physical wear and tear, which depends on operational factors such as the number of shifts for which the asset is to be used and the repair and maintenance programme, and the care and maintenance of the asset while idle.

c. technical or commercial obsolescence arising from changes or improvements in production, or from a change in the market demand for the product or service output of the asset. Expected future reductions in the selling price of an item that was produced using an asset could indicate the expectation of technical or commercial obsolescence of the asset, which, in turn, might reflect a reduction of the future economic benefits embodied in the asset.

d. legal or similar limits on the use of the asset, such as the expiry dates of related leases.

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Q.NO.5. An entity gave the following Note in its Financial Statements: 'The company chooses not to charge depreciation on Property, Plant and Equipment on account of:

a. Annual Maintenance Contracts being expensed thereby ensuring timely repairs of Plant and Machinery.

b. Depreciation being a non-cash expense has no impact on cash flows. Accordingly, it is not necessary to depreciate an asset when repairs and maintenance charges are expensed in the Statement of Profit and Loss.

c. **The values of certain assets like Property increase with passage of time, and hence charging depreciation does not make sense.**

d. **At the end of the useful life, the asset is ultimately sold, and since the asset is at cost due to no depreciation, exact profit or loss on sale of the asset is stated.'**

You are required to state the appropriateness of the above accounting policy in line with the relevant Accounting Standards.

ANSWER

Depreciation refers to writing off the value of the asset over its useful life. Such write-off is necessitated on account of normal wear-and-tear, usage, or obsolescence. Since items of Property, Plant and Equipment are generally used in generating revenue, the pro-rated write-off in value of such item should be recorded in the books against the income earned by such an asset.

Providing depreciation is mandatory, in spite of the fact that repairs are expensed in the Statement of Profit and Loss, or the value of the Property is appreciating. Depreciation is a systematic allocation of cost of the asset against the income generated from the continued use of the asset. Further, the Companies Act, 2013 mandates depreciation to be charged in order to determine the correct profits. Thus, not charging depreciation would result in non-compliance with the Companies Act provisions as well.

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The argument laid down by the company and the reasons for the same being invalid are discussed below.

a. Annual Maintenance Contracts being expensed thereby ensuring timely repairs of Plant and Machinery:

The fact that the company enters into Annual Maintenance Contracts for timely repairs can be regarded as a running cost. Such expense is incurred in order to ensure that the machine continues to run as intended. Thus, it implies that because the machine is being utilized, it will need regular repairs. In other words, continuous use is resulting in normal wear-and-tear which is the reason why depreciation should be charged by the company. By stating that the company incurs Annual Maintenance Expenses, the company is recording only the 'maintenance expenses', but not the wear-and-tear requiring the maintenance in the first place. Hence, this argument put forth by the company is not valid.

b. Depreciation being a non-cash expense has no impact on cash flows. Accordingly, it is not necessary to depreciate an asset when repairs and maintenance charges are expensed in the Statement of Profit and Loss.

When viewed from the prism of depreciation alone, it appears that the fact that depreciation is a non-cash item is correct. However, it must be noted that at the time of procurement of the asset,

the company would have paid cash. Depreciation is after all writing off this amount over the life of the asset. Hence the argument that depreciation is a non-cash item is not valid. Depreciation is writing off the cost of the asset (which was already paid for) over the useful life of the asset, and hence is mandatory.

c. The values of certain assets like Property increase with passage of time, and hence charging depreciation does not make sense.

Certain assets like immovable property do increase in value with the passage of time. However, such assets are 'used for the purposes of business' and are not 'held for sale' or held as investment property. Accordingly, since the asset is being used for carrying on business, v v 5.70 providing depreciation will give a true and fair view of the results of the company, and hence the argument that the value of the property appreciates is not valid.

If the company wants to show the fair market value of the PPE, then it has the option to apply Revaluation model. However, depreciation is mandatory to be charged in Revaluation model also.

d. At the end of the useful life, the asset is ultimately sold, and since the asset is at cost due to no depreciation, exact profit or loss on sale of the asset is stated.'

The value of any asset, after usage, will reduce. Accordingly, the argument that the 'exact profit or loss on sale of the asset' will be obtained is incorrect. Due to usage of the asset, the value of the asset would be lower than the cost. Charging depreciation would seek to bring the book value approximating to such reduced value. Thereafter, on sale of the asset, the true profit or loss would be available. Accordingly, this argument is also invalid.

It may be pertinent to note that Accounting Standard 1, Disclosure of Accounting Policies states that Disclosure of accounting policies or of changes therein cannot remedy a wrong or inappropriate treatment of the item in the accounts. In other words, the company cannot be absolved of the fact that it has not complied with the relevant accounting standards merely by giving a disclosure of incorrect policies or practices being followed.

Thus, the company's stand of disclosing the incorrect policy as a remedy is not correct. The company is suggested to charge depreciation on a systematic basis over the useful life of the asset thereby complying with the Accounting Standards.

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PRACTICAL QUESTIONS

Q.NO.1. With reference to AS-10 Revised, classify the items under the following heads:

HEADS

i. Purchase Price of Property, plant and Equipment (PPE)

ii. Directly attributable cost of PPE or

iii. Cost not included in determining the carrying amount of an item of PPE.

ITEMS

1. **Import duties and non-refundable purchase taxes.**
2. **Initial delivery and handling costs.**
3. **Initial operating losses, such as those incurred while demand for the output of an item builds up.**
4. **Costs incurred while an item capable of operating in the manner intended by management has yet to be brought into use or is operated at less than full capacity.**
5. **Trade discounts and rebates.**
6. **Costs of relocating or reorganizing part or all of the operations of an enterprise.**
7. **Installation and assembly costs.**
8. **Administration and other general overhead costs.**

SOLUTION

Heads

i. Purchase price of PPE

ii. Directly attributable cost of PPE

iii. Cost not included in determining the carrying amount of an item of PPE

	Items	Classified under Head
1.	Import duties and non-refundable purchase taxes	(i)
2.	Import duties and non-refundable purchase taxes	(ii)
3.	Initial delivery and handling costs 3 Initial operating losses, such as those incurred while demand for the output of an item builds up	(iii)
4.	Costs incurred while an item capable of operating in the manner intended by management has yet to be brought into use or is operated at less than full capacity.	(iii)
5.	Trade discounts and rebates (deducted for computing purchase price)	(i)
6.	Costs of relocating or reorganizing part or all of the operations of an	(iii)

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	enterprise.	
7.	Installation and assembly costs	(ii)
8.	Administration and other general overhead costs	(iii)

Q.NO.2. ABC Ltd. is installing a new plant at its production facility. It has incurred these costs:

1.	**Cost of the plant (cost per supplier's invoice plus taxes)**	**Rs.25,00,000**
2.	**Initial delivery and handling costs**	**Rs.2,00,000**
3.	**Cost of site preparation**	**Rs.6,00,000**
4.	**Consultants used for advice on the acquisition of the plant**	**Rs.7,00,000**
5.	**Interest charges paid to supplier of plant for deferred credit**	**Rs.2,00,000**
6.	**Estimated dismantling costs to be incurred after 7 years**	**Rs.3,00,000**
7.	**Operating losses before commercial production**	**Rs.4,00,000**

Please advise ABC Ltd. on the costs that can be capitalised in accordance with AS 10 (Revised).

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SOLUTION

According to AS 10 (Revised), these costs can be capitalised:

1.	Cost of the plant	Rs.25,00,000
2.	Initial delivery and handling costs	Rs.2,00,000
3.	Cost of site preparation	Rs.6,00,000
4.	Consultants' fees	Rs.7,00,000
5.	Estimated dismantling costs to be incurred after 7 years	Rs.3,00,000
		Rs.43,00,000

Note: Interest charges paid on "Deferred credit terms" to the supplier of the plant (not a qualifying asset) of Rs.2,00,000 and operating losses before commercial production amounting to Rs.4,00,000 are not regarded as directly attributable costs and thus cannot be capitalised. They should be written off to the Statement of Profit and Loss in the period they are incurred.

Q.NO.3. Arka Ltd. purchased machinery for Rs.3,000 lakhs. Depreciation was charged at 10% on SLM basis for a useful life of 10 years. At the end of Year 4, the machinery was revalued to Rs.2,700 lakhs and the same was adopted. What will be the carrying amount of the asset at the end of Year 5 and Year 6? Assume no change in the useful life.

SOLUTION

Particulars	Rs.in lakhs
Original Cost of the Asset	3,000.00
Less: Depreciation for 4 years (Rs.3,000 lakhs x 10% x 4 years)	(1,200.00)
Book Value at the end of Year 4	1,800.00
Add: Revaluation Surplus (balancing figure)	900.00
Revalued Amount as given (= revised depreciable value)	2,700.00
Less: Depreciation for Year 5 (Rs.2,700 lakhs ÷ 6 years)	450.00
Carrying Amount at the end of Year 5	2,250.00
Less: Depreciation for Year 6 (Rs.2,700 lakhs ÷ 6 years)	450.00
Carrying Amount at the end of Year 6	1,800.00

Q.NO.4. Skanda Ltd. acquired a machinery for Rs.2,50,00,000 five years ago. Depreciation was charged at 10% p.a. on SLM basis, useful life being 10 years. At the beginning of Year 3, the machinery was revalued to Rs.3,00,00,000 with the surplus on revaluation being credited to Revaluation Reserve. Depreciation was provided on the revalued amount over the balance useful life of 8 years. The machinery was sold in the current year for Rs.1,12,50,000. Give the accounting treatment for the above in the Company's accounts. What will be the treatment if the machinery fetched only Rs.42,50,000 now?

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SOLUTION

Particulars	**Rs.**
Original Cost of the Asset	2,50,00,000
Less: Depreciation for 2 years (Rs.2,50,00,000 x 10% x 2years)	(50,00,000)
Book Value at the end of Year 3	2,00,00,000
Add: Revaluation Surplus (balancing figure)	1,00,00,000
Revalued Amount as given (= revised depreciable value)	3,00,00,000
Less: Depreciation for Year 5 (Rs.3,00,00,000÷ 8 years x 3 yrs)	1,12,50,000
Carrying Amount at the end of Year 5	**1,87,50,000**

The treatment of Gain / Loss on Disposal / Revaluation is as below:

Particulars	Disposal Proceeds = Rs.1,12,50,000	Disposal Proceeds = Rs.42,50,000
Book Value Less Disposal Proceeds = Loss recognized in Profit or Loss	(Rs.1,87,50,000 – Rs.1,12,50,000) = Rs.75,00,000 **(Loss)**	(Rs.1,87,50,000 – Rs.42,50,000) = Rs.1,45,00,000 **(Loss)**
Revaluation Surplus directly transferred to Retained Earnings	Rs.1,00,00,000	Rs.1,00,00,000

Q.NO.5. Akshar Ltd. installed a new Plant (not a qualifying asset), at its production facility, and incurred the following costs:

- **Cost of the Plant (as per supplier's invoice): Rs.30,00,000**
- **Initial delivery and handling costs: Rs.1,00,000**
- **Cost of site preparation: Rs.2,00,000**
- **Consultant fee for advice on acquisition of Plant: Rs.50,000**
- **Interest charges paid to supplier against deferred credit: Rs.1,00,000**
- **Estimate of Dismantling and Site Restoration costs: Rs.50,000 after 10 years (Present Value is Rs.30,000)**
- **Operating losses before commercial production: Rs.40,000**

The company identified motors installed in the Plant as a separate component and a cost of Rs.5,00,000 (Purchase Price) and other costs were allocated to them proportionately. The company estimates the useful life of the Plant and those of the Motors as 10 years and 6 years respectively and SLM method of Depreciation is used.

At the end of Year 4, the company replaces the Motors installed in the Plant at a cost of Rs.6,00,000 and estimated the useful life of new motors to be 5 years. Also, the company revalued its entire class of Fixed Assets at the end of Year 4. The revalued amount of Plant as a whole is Rs.25,00,000. At the end of Year 8, the company decides to retire the Plant from active use and also disposed the Plant as a whole for Rs.6,00,000.

There is no change in the Dismantling and Site Restoration liability during the period of use. You are required to explain how the above transaction would be accounted in accordance with AS 10.

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SOLUTION

1. Cost at Initial Recognition:

Particulars	Rs.
Cost of the Plant (as per Invoice)	30,00,000
Initial Delivery and Handling Costs	1,00,000
Cost of Site Preparation	2,00,000
Consultants' Fees	50,000
Estimated Dismantling and Site Restoration Costs	30,000
Total Cost of Plant including Motors	33,80,000
Less: Cost of Motors identified as a separate component (1/6)*	5,63,333
Cost of the Plant (excluding Motors – balance 5/6)	28,16,667

* Purchase price of Motors = Rs.5,00,000 out of Rs.30,00,000 i.e., 1/6 of value of Plant

Note: Since the asset is not a qualifying asset, payment of interest to the supplier is not capitalized. Further, operating losses of Rs.40,000 incurred before commercial production is not a directly attributable cost, and hence excluded from cost of asset. These costs are expensed to the P/L as and when they are incurred.

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2. Recognition of Motors Replacement

Particulars	Rs.
Cost of Motors determined above	5,63,333
Less: Depreciation for 4 years (as per SLM)	3,75,555
5,63,333 ÷ 6 years x 4 years	
Carrying Amount of Motors at the end of Year 4	**1,87,778**

Accounting: The company should derecognize the existing Carrying Amount of Motors replaced of Rs.1,87,778. Further, the acquisition cost of new motors of Rs.6,00,000 would be capitalized as a separate component. This amount will be depreciated over the next 5 years at Rs.6,00,000 ÷ 5 years = Rs.1,20,000 p.a.

3. Revaluation

Particulars	Rs.
Cost of the Plant at initial recognition [from (1) above]	28,16,667
Less: SLM Depreciation for 4 years: Rs.28,16,667 ÷ 10 years x 4 years	11,26,667
Carrying Amount of Plant at the end of Year 4	16,90,000
Revalued Amount of Plant (Excluding Motors, since the same is treated as	

a separate component: Rs.25,00,000 – Rs.6,00,000)	19,00,000
Therefore, Gain on Revaluation credited to Revaluation Reserve	**2,10,000**
Revised Depreciation Charge p.a.: 19,00,000 ÷ 6 years	**3,16,667**

4. **Derecognition**

Particulars	Motors	Plant (excluding Motors)
Cost / Revalued Amount at end of Year 4	6,00,000	19,00,000
Less: Depreciation for Years 5-8	1,20,000 x 4 = 4,80,000	3,16,667 x 4 =12,66,668
Carrying Amount before Disposal / De-recognition	1,20,000	6,33,332
Less: Disposal Proceeds Rs.6,00,000 allocated in ratio of carrying amount	95,575	5,04,425
Loss to be written off to P/L	**24,425**	**1,28,907**

Notes:

a. The Revaluation Surplus of Rs.2,10,000 would be transferred directly to Retained Earnings.

b. The allocation of disposal proceeds of Rs.6,00,000 for the plant as whole is apportioned based on carrying amount of motors and plant (excluding motors)

Alternatively, it may be apportioned as 1/6 towards motors and 5/6 plant (excluding motors) based on the reasoning that the initially, motors amounted to 1/6 of the entire plant. This approach may not be preferable because there has been a revaluation of the plant (excluding motors) and a disposal and subsequent acquisition of the Motor, which is not in the initial proportion of 5/6 and 1/6 respectively

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Q.NO.6. Bharat Infrastructure Ltd. acquired a heavy machinery at a cost of Rs.1,000 lakhs, the breakdown of its components is not provided. The estimated useful life of the machinery is 10 years. At the end of Year 6, the turbine, which is a major component of the machinery, needed replacement, as further usage and maintenance was uneconomical. The remainder of the machine is in good condition and is expected to last for the remaining 4 years. The cost of the new turbine is Rs.450 lakhs. Give the accounting treatment for the new turbine, assuming SLM Depreciation and a discount rate of 8%.

SOLUTION

As per AS 10, Property, Plant and Equipment, the derecognition of the carrying amount of components of an item of Property, Plant and Equipment occurs regardless of whether the cost of the previous part / inspection was identified in the transaction in which the item was acquired or constructed. If it is not practicable for an enterprise to determine the carrying amount of the replaced part/ inspection, it may use the cost of the replacement or the estimated cost of a future similar inspection as an indication of what the cost of the replaced part/ existing inspection component was when the item was acquired or constructed.

In the given case, the new turbine will produce economic benefits to Bharat Infrastructure Ltd. and the cost is measurable. Since the recognition criteria is fulfilled, the same should be recognised as a separate item of Property, Plant and Equipment. However, since the initial breakup of the components is not available, the cost of the replacement of Rs.450 lakhs can be used as an indication based on the guidance given above, discounted at 8% for the 6-year period lapsed.

Thus, estimate of cost 6 years back = Rs.450 lakhs ÷ 1.086 = Rs.283.58 lakhs

Current carrying amount of turbine (to be de-recognised) = Estimated cost Rs.283.58 lakhs (–) SLM depreciation at 10% (useful life 10 years) for 6 years Rs.170.15 lakhs= Rs.113.43 lakhs.

Hence revised carrying amount of the machinery will be as under:

Particulars	Rs.
Historical Cost [Rs.1,000 lakhs (–) SLM Depreciation at 10% (10 year life) for 6 years]	400.00
Add: Cost of new turbine	450.00
Less: Derecognition of current carrying amount of old turbine	(113.43)
New Carrying Amount of Machinery	**736.57**

Q.NO.7. Preet Ltd. intends to set up a steel plant, for which it has acquired a dilapidated factor having an area of 5,000 acres at a cost of Rs.60,000 per acre. Preet Ltd. has incurred Rs.1.10 crores on demolishing the old Factory Building thereon. A sum of Rs.63,00,000 (including 5% GST thereon) was realized from the sale of material salvaged from the site. Preet Ltd. incurred Stamp Duty and Registration Charges of 7% of land value, paid legal and consultancy charges Rs.8,00,000 for land acquisition and incurred Rs.1,25,000 on title guarantee insurance. Compute the value of the land acquired.

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SOLUTION

Particulars	Rs.
Purchase Price: 5,000 acres x Rs.60,000 per acre	3,000.00
Stamp Duty and Registration Charges at 7%	210.00
Legal and Consultancy Fees	8.00
Title Guarantee Insurance	1.25
Demolition Expenses (Net of Salvage Income)	50.00
[Rs.110 lakhs (–) Rs.60 lakhs (Rs.63 lakhs x 100/105)]	
Cost of Land	**3,269.25**

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UNIT 3: ACCOUNTING STANDARD 13: ACCOUNTING FOR INVESTMENTS

LEARNING OUTCOMES

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

- What are the various Forms of Investments
- Classification of Investments
- How to compute the Cost of Investments
  - Current Investments
  - Long-term Investments
  - Investment Properties
- Disposal of Investments
- Reclassification of Investments
- Disclosure Requirements as per the standard.

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3.1 INTRODUCTION

The standard deals with accounting for investments in the financial statements of enterprises and related disclosure requirements.

Shares, debentures and other securities held as stock-in-trade (i.e., for sale in the ordinary course of business) are not 'investments' as defined in this Standard. However, the manner in which they are accounted for and disclosed in the financial statements is quite similar to that applicable in respect of current investments. Accordingly, the provisions of this Standard, to the extent that they relate to current investments, are also applicable to shares, debentures and other securities held as stock-in-trade, with suitable modifications as specified in this Standard.

This Standard does not deal with:

a. The basis for recognition of interest, dividends and rentals earned on investments which are covered by AS 9

b. Operating or finance leases

c. Investments on retirement benefit plans and life insurance enterprises

d. Mutual funds, venture capital funds and/ or the related asset management companies, banks and public financial institutions formed under a Central or State Government Act or so declared under the Companies Act, 2013.

3.2 DEFINITION OF THE TERMS USED IN THE STANDARD

Investments are assets held by an enterprise for earning income by way of dividends, interest, and rentals, for capital appreciation, or for other benefits to the investing enterprise. Assets held as **stock-in-trade (inventory) are not 'investments'**

Fair value is the amount for which an asset could be exchanged between a knowledgeable, willing buyer and a knowledgeable, willing seller in an arm's length transaction. Under appropriate circumstances, market value or net realisable value provides an evidence of fair value.

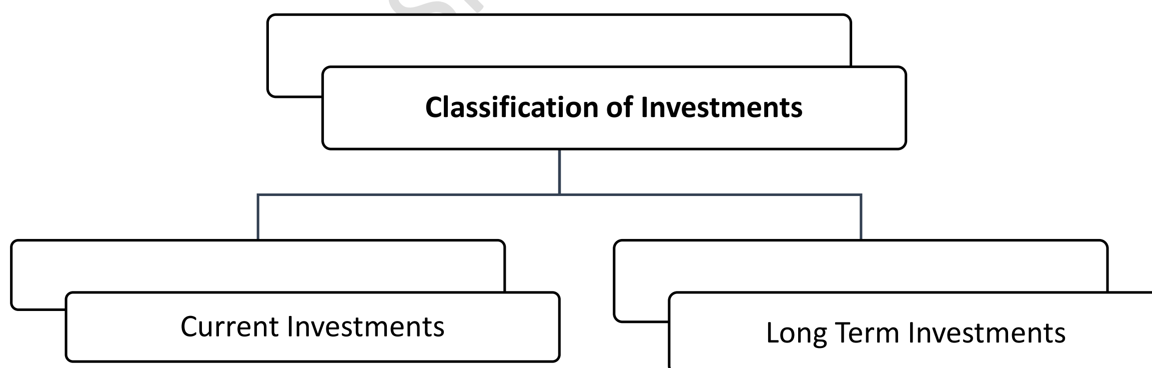
Market value is the amount obtainable from the sale of an investment in an open market, net of expenses necessarily to be incurred on or before disposal.

3.3 FORMS OF INVESTMENTS

Enterprises hold investments for diverse reasons. For some enterprises, investment activity is a significant element of operations, and assessment of the performance of the enterprise may largely, or solely, depend on the reported results of this activity.

Some investments have no physical existence and are represented merely by certificates or similar documents (e.g., shares) while others exist in a physical form (e.g., buildings). For some investments, an active market exists from which a market value (fair value) can be established. For other investments, an active market does not exist and other means are used to determine fair value.

3.4 CLASSIFICATION OF INVESTMENTS



A current investment is an investment that is by its nature readily realisable and is intended to be held for not more than one year from the date on which such investment is made. The intention to hold for not more than one year is to be judged at the time of purchase of investment.

A long term investment is an investment other than a current investment.

Further classification of current and long-term investments should be as specified in the statute governing the enterprise. In the absence of a statutory requirement, such further classification should disclose, where applicable, investments in:

a. Government or Trust securities

b. Shares, debentures or bonds

c. Investment properties

d. Others—specifying nature

3.5 COST OF INVESTMENTS

The cost of an investment includes acquisition charges such as brokerage, fees and duties etc.

Example

X Ltd invests in long-term deposit worth Rs. 200 lakhs on 1st April 2022. It incurs brokerage cost of Rs.1 lakh to be able to make the investment. The value of the investment on 1st April 2022 is Rs.201 lakhs.

If an investment is acquired, or partly acquired, by the issue of shares or other securities, the acquisition cost is the fair value of the securities issued. The fair value may not necessarily be equal to the nominal or par value of the securities issued.

If an investment is acquired in exchange, or part exchange, for another asset, the acquisition cost of the investment is determined by reference to the fair value of the asset given up or the fair value of the investment acquired, whichever is more clearly evident.

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.

For 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 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 right shares offered are subscribed for, the cost of the right shares is added to the carrying amount of the original holding. If rights are not subscribed for but are sold in the market, the sale proceeds are taken to the profit and loss statement.

However, where the investments are acquired on cum-right basis and the market value of investments immediately after their becoming ex-right is lower than the cost for which they were acquired, it may be appropriate to apply the sale proceeds of rights to reduce the carrying amount of such investments to the market value.

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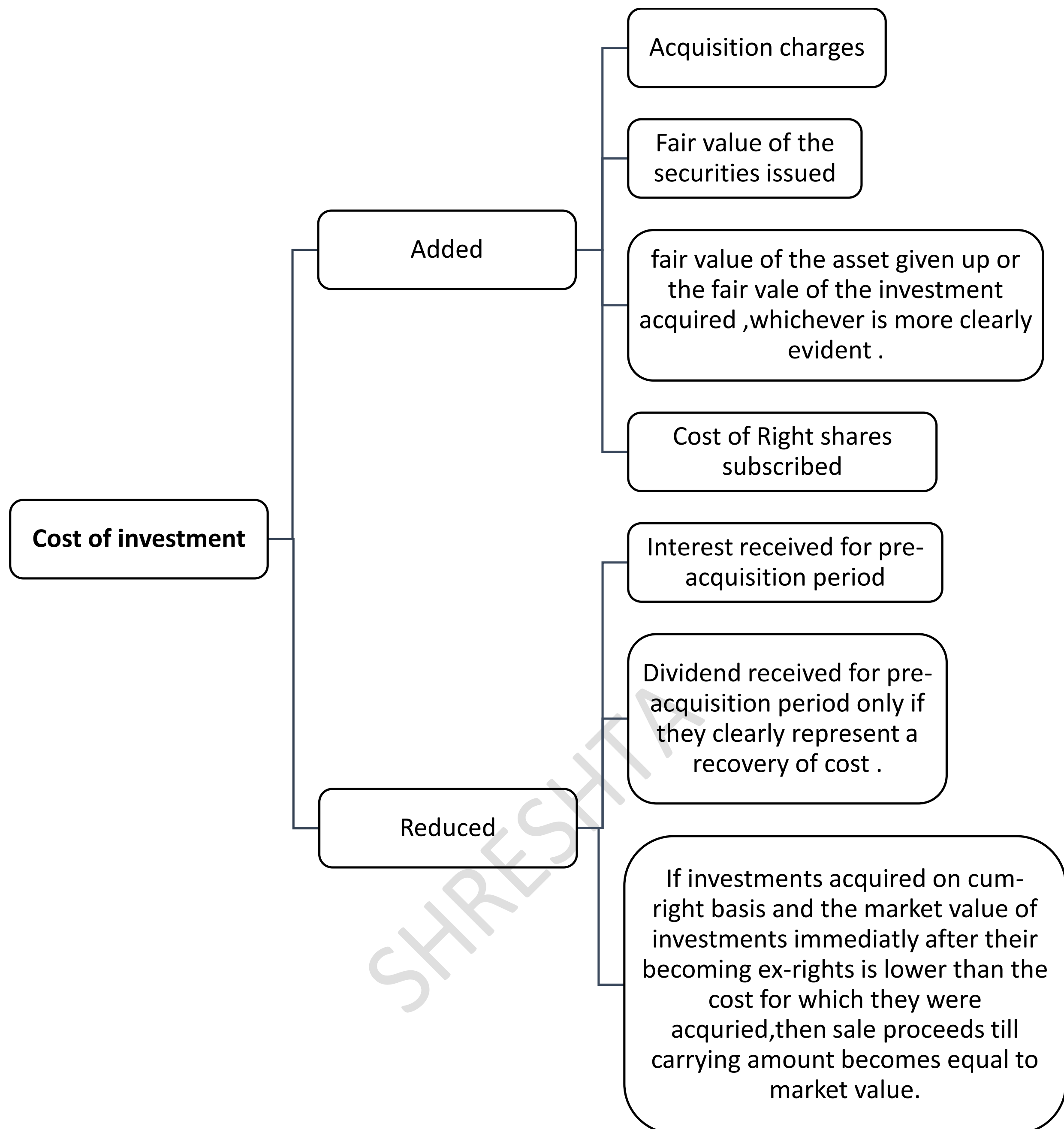


3.6 CARRYING AMOUNT OF INVESTMENTS

The carrying amount for current investments is the lower of cost and fair value.

Valuation of current investments on overall (or global) basis is not considered appropriate. Sometimes, the concern of an enterprise may be with the value of a category of related current investments and not with each individual investment, and accordingly the investments may be carried at the lower of cost and fair value computed category-wise (i.e. equity shares, preference shares, convertible debentures, etc.). However, the more prudent and appropriate method is to carry investments individually at the lower of cost and fair value.

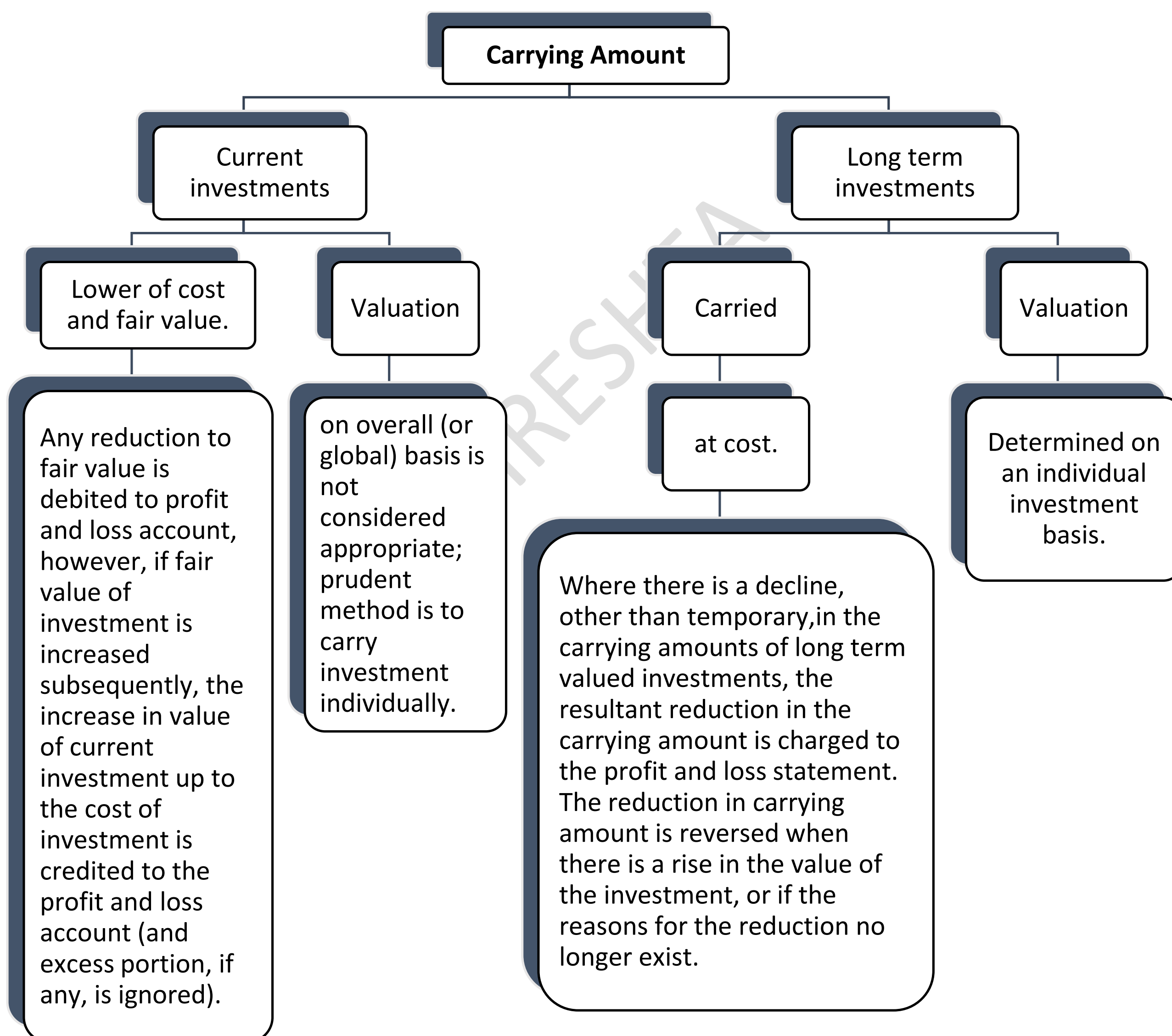
Any reduction to fair value is debited to profit and loss account, however, if fair value of investment is increased subsequently, the increase in value of current investment up to the cost of investment is credited to the profit and loss account (and excess portion, if any, is ignored).

Long term investments are usually carried at cost. The carrying amount of long-term investments is therefore determined on an individual investment basis. Where there is a decline, other than temporary, in the carrying amounts of long term valued investments, the resultant reduction in the carrying amount is charged to the profit and loss statement. The reduction in carrying amount is reversed when there is a rise in the value of the investment, or if the reasons for the reduction no longer exist. Example of Decline other than temporary:

A. Company in which investment is made is making cash operating losses which has resulted in reduction of its net worth,

B. New regulation which has negative impact in the working of the investee,

C. Significant reduction of quoted price of the investment, etc.



(Refer Illustration 1 & 2)

3.7 INVESTMENT PROPERTIES

An investment property is an investment in land or buildings that are not intended to be occupied substantially for use by, or in the operations of, the investing enterprise.

An investment property is accounted for in accordance with cost model as prescribed in AS 10 (Revised), ‘Property, Plant and Equipment’. The cost of any shares in a co-operative society or a company, the holding of which is directly related to the right to hold the investment property, is added to the carrying amount of the investment property.

3.8 DISPOSAL OF INVESTMENTS

On disposal of an investment, the difference between the carrying amount and the disposal proceeds, net of expenses, is recognised in the profit and loss statement.

When disposing of a part of the holding of an individual investment, the carrying amount to be allocated to that part is to be determined on the basis of the average carrying amount of the total holding of the investment[1].

3.9 RECLASSIFICATION OF INVESTMENTS

Where **long-term investments** are reclassified as **current investments**, transfers are made at the lower of cost and carrying amount at the date of transfer.

Where investments are reclassified **from current to long-term**, transfers are made at the lower of cost and fair value at the date of transfer.

(Refer Illustration 3)

3.10 DISCLOSURE

The following disclosures in financial statements in relation to investments are appropriate: -

a. The accounting policies followed for the determination of carrying amount of investments’.

b. The amounts included in profit and loss statement for:

- **i.** Interest, dividends (showing separately dividends from subsidiary companies), and rentals on investments showing separately such income from long term and current investments. Gross income should be stated, the amount of income tax deducted at source being included under Advance Taxes Paid.
- **ii.** Profits and losses on disposal of current investments and changes in carrying amount of such investments.
- **iii.** Profits and losses on disposal of long term investments and changes in the carrying amount of such investments.

c. Significant restrictions on the right of ownership, realisability of investments or the remittance of income and proceeds of disposal.

d. The aggregate amount of quoted and unquoted investments, giving the aggregate market value of quoted investments.

e. Other disclosures as specifically required by the relevant statute governing the enterprise.

f. Classification of investments.

(Refer Illustration 4 - 9)

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ILLUSTRATIONS

Illustration 1

An unquoted long term investment is carried in the books at a cost of Rs. 2 lakhs. The published accounts of the unlisted company received in May, 20X1 showed that the company was incurring cash losses with declining market share and the long term investment may not fetch more than Rs.20,000. How will you deal with this in preparing the financial statements of R Ltd. for the year ended 31st March, 20X1?

Solution

As stated in the question that financial statements for the year ended 31st March, 20X1 are still under preparation – The answer has been given on the assumption that the financial statements are yet to be completed and approved by the Board of Directors.

Also, the fall in value of investments has been considered on account of conditions existing on the balance sheet date.

Investments classified as long term investments should be carried in the financial statements at cost. However, provision for diminution should be made to recognise a decline, other than temporary, in the value of the investments, such reduction being determined and made for each investment individually. AS 13 (Revised) 'Accounting for Investments' states that indicators of the value of an investment are obtained by reference to its market value, the investee's assets and results and the expected cash flows from the investment. On the above basis, the facts of the given case clearly suggest that the provision for diminution should be made to reduce the carrying amount of long term investment to Rs. 20,000 in the financial statements for the year ended 31st March, 20X1.

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Illustration 2

X Ltd. on 1-1-20X1 had made an investment of Rs. 600 lakhs in the equity shares of Y Ltd. of which 50% is made in the long term category and the rest as temporary investment. The realisable value of all such investment on 31-3-20X1 became Rs. 200 lakhs as Y Ltd. lost a case of copyright. From the given market conditions, it is apparent that the reduction in the value is not temporary in nature. How will you recognise the reduction in financial statements for the year ended on 31-3-20X1?

Solution

X Ltd. invested Rs. 600 lakhs in the equity shares of Y Ltd. Out of the same, the company intends to hold 50% shares for long term period i.e. Rs. 300 lakhs and remaining as temporary (current) investment i.e. Rs. 300 lakhs. Irrespective of the fact that investment has been held by X Ltd. only for 3 months (from 1.1.20X1 to 31.3.20X1), AS 13 (Revised) lays emphasis on intention of the investor to classify the investment as current or long term even though the long term investment may be readily marketable.

In the given situation, the realisable value of all such investments on 31.3.20X1 became Rs. 200 lakhs i.e. Rs. 100 lakhs in respect of current investment and Rs. 100 lakhs in respect of long term investment.

As per AS 13 (Revised), 'Accounting for Investment', the carrying amount for current investments is the lower of cost and fair value. In respect of current investments for which an active market exists, market value generally provides the best evidence of fair value.

Accordingly, the carrying value of investment held as temporary investment should be shown at realisable value i.e. at Rs. 100 lakhs. The reduction of Rs. 200 lakhs in the carrying value of current investment will be charged to the profit and loss account.

The Standard further states that long-term investments are usually carried at cost. However, when there is a decline, other than temporary, in the value of long term investment, the carrying amount is reduced to recognise the decline.

Here, Y Ltd. lost a case of copyright which drastically reduced the realisable value of its shares to one third which is quiet a substantial figure. Losing the case of copyright may affect the business and the performance of the company in the long run. Accordingly, it will be appropriate to reduce the carrying amount of long term investment by Rs. 200 lakhs and show the investments at Rs. 100 lakhs, since the downfall in the value of shares is other than temporary. The reduction of Rs. 200 lakhs in the carrying value of long term investment will also be charged to the Statement of profit and loss.

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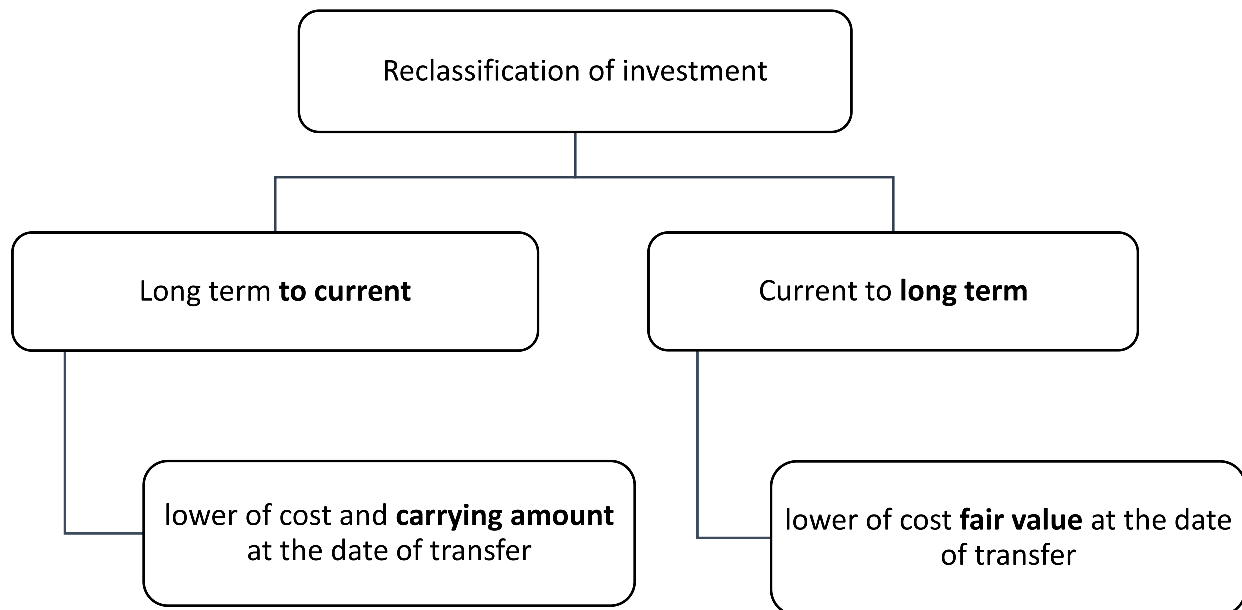
Illustration 3

ABC Ltd. wants to re-classify its investments in accordance with AS 13 (Revised). Decide and state on the amount of transfer, based on the following information:

1. **A portion of current investments purchased for Rs. 20 lakhs, to be reclassified as long term investment, as the company has decided to retain them. The market value as on the date of Balance Sheet was Rs. 25 lakhs.**
2. **Another portion of current investments purchased for Rs. 15 lakhs, to be reclassified as long term investments. The market value of these investments as on the date of balance sheet was Rs. 6.5 lakhs.**
3. **Certain long term investments no longer considered for holding purposes, to be reclassified as current investments. The original cost of these was Rs. 18 lakhs but had been written down to Rs. 12 lakhs to recognise other than temporary decline as per AS 13 (Revised).**



Solution

As per AS 13 (Revised), where investments are reclassified from current to long term, transfers are made at the lower of cost and fair value at the date of transfer.

1. In the first case, the market value of the investment is Rs. 25 lakhs, which is higher than its cost i.e. Rs. 20 lakhs. Therefore, the transfer to long term investments should be carried at cost i.e. Rs. 20 lakhs.
2. In the second case, the market value of the investment is Rs. 6.5 lakhs, which is lower than its cost i.e. Rs. 15 lakhs. Therefore, the transfer to long term investments should be carried in the books at the market value i.e. Rs. 6.5 lakhs. The loss of Rs. 8.5 lakhs should be charged to profit and loss account.

   As per AS 13 (Revised), where long-term investments are re-classified as current investments, transfers are made at the lower of cost and carrying amount at the date of transfer.
3. In the third case, the book value of the investment is Rs. 12 lakhs, which is lower than its cost i.e. Rs. 18 lakhs. Here, the transfer should be at carrying amount and hence this re-classified current investment should be carried at Rs. 12 lakhs.

Illustration 4

M/s Innovative Garments Manufacturing Company Limited invested in the shares of another company on 1st October, 20X3 at a cost of Rs. 2,50,000. It also earlier purchased Gold of Rs. 4,00,000 and Silver of Rs. 2,00,000 on 1st March, 20X1. Market value as on 31st March, 20X4 of above investments are as follows:

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Particulars	Rs.
Shares	**2,25,000**
Gold	**6,00,000**
Silver	**3,50,000**

How above investments will be shown in the books of accounts of M/s Innovative Garments Manufacturing Company Limited for the year ending 31st March, 20X4 as per the provisions of Accounting Standard 13 "Accounting for Investments"?

Solution

As per AS 13 (Revised) 'Accounting for Investments', for investment in shares if the investment is purchased with an intention to hold for short-term period (less than one year), then it will be classified as current investment and to be carried at lower of cost and fair value, i.e., in case of shares, at lower of cost (Rs. 2,50,000) and market value (Rs. 2,25,000) as on 31 March 20X4, i.e., Rs. 2,25,000.

If equity shares are acquired with an intention to hold for long term period (more than one year), then should be considered as long-term investment to be shown at cost in the Balance Sheet of the company. However, provision for diminution should be made to recognise a decline, if other than temporary, in the value of the investments.

Gold and silver are generally purchased with an intention to hold it for long term period (more than one year) until and unless given otherwise. Hence, the investment in Gold and Silver (purchased on 1st March, 20X1) should continue to be shown at cost (since there is no 'other than temporary' diminution) as on 31st March, 20X4, i.e., Rs. 4,00,000 and Rs. 2,00,000 respectively, though their market values have been increased.

Illustration 5

In 20X1, M/s. Wye Ltd. issued 12% fully paid debentures of Rs. 100 each, interest being payable half yearly on 30th September and 31st March of every accounting year.

On 1st December, 20X2, M/s. Bull & Bear purchased 10,000 of these debentures at Rs. 101 ex-interest price, also paying brokerage @ 1% of ex-interest amount of the purchase. On 1st March, 20X3 the firm sold all these debentures at Rs. 103 ex-interest price, again paying brokerage @ 1 % of ex-interest amount. Prepare Investment Account in the books of M/s. Bull & Bear for the period 1st December, 20X2 to 1st March, 20X3.

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Solution

In the books of M/s Bull & Bear

Investment Account

for the period from 1st December 20X2 to 1st March, 20X3

(Scrip: 12% Debentures of M/s. Wye Ltd.)

Date	Particulars	Nominal Value (Rs.)	Interest	Cost (Rs.)	Date	Particulars	Nominal Value (Rs.)	Interest	Cost (Rs.)
1.12.20X2	To Bank A/c (W.N.1)	10,00,000	20,000	10,20,100	1.03.20X3	By Bank A/c (W.N.2)	10,00,000	50,000	10,19,700
1.3.20X3	To Profit & loss A/c* (b.f.)	-	30,000		1.3.20X3	By Profit & loss A/c (b.f.)			400
		10,00,000	50,000	10,20,100			10,00,000	50,000	10,20,100

* This represents income for M/s. Bull & Bear for the period 1st December, 20X2 to 1st March, 20X3, i.e., interest for three months- 1 st December, 20X2 to 28 February, 20X3).

Working Notes:

	Rs.
1. Cost of 12% debentures purchased on 1.12.20X2	
Cost Value (10,000 × Rs. 101)	= 10,10,000
Add: Brokerage (1% of Rs. 10,10,000)	= 10,100
Total	= 10,20,100
2. Sale proceeds of 12% debentures sold	**Rs.**
Sales Price (10,000 × Rs. 103)	= 10,30,000
Less: Brokerage (1% of Rs. 10,30,000)	= (10,300)
Total	= 10,19,700

Illustration 6

On 1.4.20X1, Mr. Krishna Murty purchased 1,000 equity shares of Rs. 100 each in TELCO Ltd. @ Rs. 120 each from a Broker, who charged 2% brokerage. He incurred 50 paise per Rs. 100 as cost of shares transfer stamps. On 31.1.20X2, Bonus was declared in the ratio of 1: 2. Before and after the record date of bonus shares, the shares were quoted at Rs. 175 per share and Rs. 90 per share respectively. On 31.3.20X2, Mr. Krishna Murty sold bonus shares to a Broker, who charged 2% brokerage.

Show the Investment Account in the books of Mr. Krishna Murty, who held the shares as Current assets and closing value of investments shall be made at Cost or Market value whichever is lower.

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Solution

In the books of Mr. Krishna Murty

Investment Account for the year ended 31st March, 20X2

(Scrip: Equity Shares of TELCO Ltd.)

Date	Particulars	Nominal Value (Rs.)	Cost (Rs.)	Date	Particulars	Nominal Value (Rs.)	Cost (Rs.)
1.4.20X1	To Bank A/c (W.N.1)	1,00,000	1,23,000	31.3.20X2	By Bank A/c (W.N.2)	50,000	44,100
31.1.20X2	To Bonus shares (W.N.5)	50,000	–	31.3.20X2	By Balance c/d (W.N.4)	1,00,000	82,000
31.3.20X2	To Profit & loss A/c (W.N.3)	–	3,100				
		1,50,000	1,26,100			1,50,000	1,26,100

Working Notes:

1. Cost of equity shares purchased on 1.4.20X1 = (1,000 ×Rs. 120) + (2% of Rs. 1,20,000) + (½% of Rs. 1,20,000) = Rs. 1,23,000
2. Sale proceeds of equity shares (bonus) sold on 31st March, 20X2= (500 ×Rs. 90) – (2% of Rs. 45,000) = Rs. 44,100.
3. Profit on sale of bonus shares on 31st March, 20X2

   = Sale proceeds – Average cost

   Sale proceeds = Rs. 44,100

   Average cost = Rs. (1,23,000 /1,50,000) x 50,000 = Rs. 41,000

   Profit = Rs. 44,100 – Rs. 41,000 = Rs. 3,100.
4. Valuation of equity shares on 31st March, 20X2

   Cost = (Rs. 1,23,000/1,50,000) x 1,00,000 = Rs. 82,000

   Market Value = 1,000 shares × Rs. 90 = Rs. 90,000

   Closing balance has been valued at Rs. 82,000 being lower than the market value.
5. Bonus shares do not have any cost.

Illustration 7

Mr. X purchased 500 equity shares of Rs. 100 each in Omega Co. Ltd. for Rs. 62,500 inclusive of brokerage and stamp duty. Some years later the company resolved to capitalise its profits and to issue to the holders of equity shares, one equity bonus share for every share held by them. Prior to capitalisation, the shares of Omega Co. Ltd. were quoted at Rs. 175 per share. After the capitalisation, the shares were quoted at Rs. 92.50 per share. Mr. X. sold the bonus shares and received at Rs. 90 per share.

Prepare the Investment Account in X's books on average cost basis.

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Solution

In the books of X

Investment Account

[Scrip: Equity shares in Omega Co. Ltd.]

Particulars	Nominal Value Rs.	Cost Rs.	Particulars	Nominal Value Rs.	Cost Rs.
To Cash	50,000	62,500	By Cash - Sale (500 x 90)	50,000	45,000
To Bonus shares (W.N.1)	50,000	-	By Balance c/d (W.N. 3)	50,000	31,250
To P & L A/c (W.N. 2)	-	13,750			
	1,00,000	76,250		1,00,000	76,250
To Balance b/d	50,000	31,250			

Working Notes:

1. Bonus shares do not have any cost.
2. Profit on sale of bonus shares = Sales proceeds – Average cost

   Sales proceeds = Rs. 45,000

   Average cost = $\frac{500}{1000} \times 62{,}500$ = Rs.31,250

   Profit = Rs. 45,000 – Rs.31,250 = Rs. 13,750.
3. Valuation of Closing Balance of Shares at the end of year

   The total cost of 1,000 share including bonus is Rs.62,500

   Therefore, cost of 500 shares (carried forward) is $\frac{500}{1000} \times 62{,}500$ = Rs. 31,250

   Market price of 500 shares = 92.50 x 500 = Rs. 46,250

   Cost being lower than the market price, therefore shares are carried forward at cost.

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Illustration 8

On 1st April, 20X1, Rajat has 50,000 equity shares of P Ltd. at a book value of Rs. 15 per share (nominal value Rs. 10 each). He provides you the further information:

1. **On 20th June, 20X1 he purchased another 10,000 shares of P Ltd. at Rs. 16 per share.**
2. **On 1st August, 20X1, P Ltd. issued one equity bonus share for every six shares held by the shareholders.**
3. **On 31st October, 20X1, the directors of P Ltd. announced a right issue which entitles the holders to subscribe three shares for every seven shares at Rs. 15 per share. Shareholders can transfer their rights in full or in part.**

Rajat sold 1/3rd of entitlement to Umang for a consideration of Rs. 2 per share and subscribed the rest on 5th November, 20X1.

You are required to prepare Investment A/c in the books of Rajat for the year ending 31st March, 20X2.

Solution

In the books of Rajat

Investment Account

(Equity shares in P Ltd.)

Date	Particulars	No. of shares	Amount (Rs.)	Date	Particulars	No. of shares	Amount (Rs.)
1.4.X1	To Balance b/d	50,000	10,000	31.3.X2	By Balance c/d (Bal. fig.)	90,000	12,10,000
20.6.X1	To Bank A/c	10,000	1,60,000				
1.8.X1	To Bonus issue (W.N.1)	10,000	-				
5.11.X1	To Bank A/c (right shares) (W.N.4)	20,000	3,00,000				
		90,000	12,10,000			90,000	12,10,000

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Working Notes:

1. Bonus shares = $\frac{50{,}000 + 10{,}000}{6}$ =10,000 shares
2. Right shares = $\frac{50{,}000 + 10{,}000 + 10{,}000}{7} \times 3 = 30{,}000$ shares
3. Sale of rights = 30,000 shares× $\times \frac{1}{3} \times \text{Rs.}2 = \text{Rs.}20{,}000$ to be credited to statement of profit and loss
4. Rights subscribed = 30,000 shares $\times \frac{2}{3} \times \text{Rs.}15 = \text{Rs.}3{,}00{,}00\ 0$

Illustration 9

On 1.4.20X1, Sundar had 25,000 equity shares of 'X' Ltd. at a book value of Rs. 15 per share (Nominal value Rs. 10). On 20.6.20X1, he purchased another 5,000 shares of the company at Rs.16 per share. The directors of 'X' Ltd. announced a bonus and rights issue.

No dividend was payable on these issues. The terms of the issue are as follows:

Bonus basis 1:6 (Date 16.8.20X1).

Rights basis 3:7 (Date 31.8.20X1) Price Rs. 15 per share.

Due date for payment 30.9.20X1.

Shareholders were entitled to transfer their rights in full or in part. Accordingly, Sundar sold 33.33% of his entitlement to Sekhar for a consideration of Rs. 2 per share.

Dividends: Dividends for the year ended 31.3.20X1 at the rate of 20% were declared by X Ltd. and received by Sundar on 31.10.20X1. Dividends for shares acquired by him on 20.6.20X1 are to be adjusted against the cost of purchase.

On 15.11.20X1, Sundar sold 25,000 equity shares at a premium of Rs. 5 per share.

You are required to prepare in the books of Sundar.

1. **Investment Account**
2. **Profit & Loss Account. For your exercise, assume that the books are closed on 31.12.20X1and shares are valued at average cost.**

Solution

Books of Sundar

Investment Account (Scrip: Equity Shares in X Ltd.)

		No.	Amount Rs.			No.	Amount Rs.
1.4.20X1	To Bal b/d	25,000	3,75,000	31.10.20X1	By Bank (dividend on shares acquired on 20/6/20X1) (W.N.4)	—	10,000
20.6.20X1	To Bank	5,000	80,000				
16.8.20X1	To Bonus (W.N.1)	5,000	—				
30.9.20X1	To Bank (Rights Shares) (W.N.3)	10,000	1,50,000	15.11.20X1	By Bank (Sale of shares)	25,000	3,75,000
15.11.20X1	To Profit (on sale of shares)		44,444	31.12.20X1	By Bal. c/d (W.N.6)	20,000	2,64,444
		45,000	6,49,444			45,000	6,49,444

Profit and Loss Account (An extract)

To Balance c/d 1,04,444	1,04,444	By Profit transferred	44,444
		By Sale of rights (W.N.3)	10,000
		By Dividend (W.N.4)	50,000
	1,04,444		1,04,444

Working Notes:

1. **Bonus Shares** = $\left(\frac{25{,}000+5{,}000}{6}\right)$ = 5,000 shares

2. **Right Shares** = $\left(\frac{25{,}000+5{,}000+5{,}000}{7}\right)\times 3$ = 15,000 shares

3. **Right shares renounced** = 15,000×1/3 = 5,000 shares

   Sale of right shares = 5,000 x 2 = Rs. 10,000

   Right shares subscribed = 15,000 – 5,000 = 10,000 shares

   Amount paid for subscription of right shares = 10,000 x 15 = Rs.1,50,000

4. **Dividend received** = 25,000 (shares as on 1st April 20X1) × 10 × 20% = Rs.50,000

   Dividend on shares purchased on 20.6.20X1 = 5,000 × 10 × 20% = Rs.10,000 is adjusted to Investment A/c

5. **Profit on sale of 25,000 shares**

   = Sales proceeds – Average cost

   Sales proceeds = Rs. 3,75,000

   Average cost = $\left(\frac{3{,}75{,}000+80{,}000+1{,}50{,}000-10{,}000}{45{,}000}\right)\times 25{,}000 = \text{Rs.}3{,}30{,}556$

   Profit = Rs.3,75,000– Rs.3,30,556= Rs.44,444.

6. **Cost of shares on 31.12.20X1**

   $\left(\frac{3{,}75{,}000+80{,}000+1{,}50{,}000-10{,}000}{45{,}000}\right)\times 20{,}000 = \text{Rs.}2{,}64{,}444$

Reference: The students are also advised to refer the full bare text of AS 13 (Revised) "Accounting for Investments".

SHRESHTA

TEST YOUR KNOWLEDGE

MCQs

1. **The cost of Right shares is**
   a. **added to the cost of investments.**
   b. **subtracted from the cost of investments.**
   c. **no treatment is required.**
   d. **added to cost of investments at market value.**

2. **Long term investments are carried at**
   a. **fair value.**
   b. **cost less 'other than temporary' decline.**
   c. **Cost and market value whichever is less.**
   d. **Cost and market value whichever is higher.**

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

SHRESHTA

4. **A Ltd. acquired 2,000 equity shares of Omega Ltd. on cum-right basis at Rs. 75 per share. Subsequently, omega Ltd. made a right issue of 1:1 at Rs. 60 per share, which was subscribed for by A. Total cost of investments at the year - end will be Rs.**
   a. **2,70,000.**
   b. **1,50,000.**
   c. **1,20,000.**
   d. **1,70,000.**

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

ANSWERS/SOLUTIONS

MCQs

1.	**a.**	added to the cost of investments.
2.	**b.**	cost less ‘other than temporary’ decline.
3.	**c.**	Cost and fair value, whichever is less.
4.	**a.**	2,70,000.
5.	**c.**	Both (a) and (b).

THEORY QUESTIONS

Q.NO.1. Briefly explain disclosure requirements for Investments as per AS-13.

ANSWER

The disclosure requirements as per AS 13 (Revised) are as follows:

i. Accounting policies followed for the determination of carrying amount of investments.

ii. Classification of investment into current and long term.

iii. The amount included in profit and loss statements for

- **a.** Interest, dividends and rentals for long term and current investments, disclosing therein gross income and tax deducted at source thereon;
- **b.** Profits and losses on disposal of current investment and changes in carrying amount of such investments;
- **c.** Profits and losses and disposal of long term investments and changes in carrying amount of investments.

iv. Aggregate amount of quoted and unquoted investments, giving the aggregate market value of quoted investments;

v. Any significant restrictions on investments like minimum holding period for sale/disposal, utilisation of sale proceeds or non-remittance of sale proceeds of investment held outside India.

vi. Other disclosures required by the relevant statute governing the enterprises

SHRESHTA

Q.NO.2. How will you classify the investments as per AS 13? Explain in Brief.

ANSWER

The investments are classified into two categories as per AS 13, viz., Current Investments and Long-term Investments. A current Investment is an investment that is by its nature readily realisable and is intended to be held for not more than one year from the date on which such investment is made. The carrying amount for current investments is the lower of cost and fair value. Any reduction to fair value and any reversals of such reductions are included in the statement of profit and loss.

A long-term investment is an investment other than a current investment. 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 recognise the decline. The reduction in carrying amount is charged to the statement of profit and loss.

Q.NO.3. Whether the accounting treatment 'at cost' under the head 'Long Term Investments' without providing for any diminution in value is correct and in accordance with the provisions of AS 13. If not, what should have been the accounting treatment in such a situation? Explain in brief.

ANSWER

The accounting treatment 'at cost' under the head 'Long Term Investment' in the financial statements of the company without providing for any diminution in value is correct and is in accordance with the provisions of AS 13 provided that there is no decline, other than temporary, in the value of investment. If the decline in the value of investment is, other than temporary, compared to the time when the shares were purchased, provision is required to be made.

SHRESHTA

PRACTICAL QUESTIONS

Q.NO.1. Mr. X acquires 200 shares of a company on cum-right basis for Rs. 70,000. He subsequently receives an offer of right to acquire fresh shares in the company in the proportion of 1:1 at Rs. 107 each. He does not subscribe but sells all the rights for Rs. 12,000. The market value of the shares after their becoming ex-rights has also gone down to Rs. 60,000. What should be the accounting treatment in this case?

SOLUTION

As per AS 13, where the investments are acquired on cum-right basis and the market value of investments immediately after their becoming ex-right is lower than the cost for which they were acquired, it may be appropriate to apply the sale proceeds of rights to reduce the carrying amount of such investments to the market value. In this case, the amount of the ex-right market value of 200 shares bought by X immediately after the declaration of rights falls to Rs. 60,000. In this case, out of sale proceeds of Rs. 12,000, Rs. 10,000 may be applied to reduce the carrying amount to bring it to the market value and Rs. 2,000 would be credited to the profit and loss account.

Q.NO.2. On 1st April, 20X1, XY Ltd. has 15,000 equity shares of ABC Ltd. at a book value of Rs. 15 per share (nominal value Rs. 10 per share). On 1st June, 20X1, XY Ltd. acquired 5,000 equity shares of ABC Ltd. for Rs. 1,00,000. ABC Ltd. announced a bonus and right issue.

1. **Bonus was declared, at the rate of one equity share for every five shares held, on 1st July 20X1.**
2. **Right shares are to be issued to the existing shareholders on 1st September 20X1. The company will issue one right share for every 6 shares at 20% premium. No dividend was payable on these shares.**
3. **Dividend for the year ended 31.3.20X1 were declared by ABC Ltd. @ 20%, which was received by XY Ltd. on 31st October 20X1.**

   XY Ltd.

   i. **Took up half the right issue.**
   ii. **Sold the remaining rights for Rs. 8 per share.**
   iii. **Sold half of its shareholdings on 1st January 20X2 at Rs. 16.50 per share. Brokerage being 1%.**

   You are required to prepare Investment account of XY Ltd. for the year ended 31st March 20X2 assuming the shares are being valued at average cost.

SHRESHTA

SOLUTION

In the books of XY Ltd.

Investment in equity shares of ABC Ltd.

for the year ended 31st March, 20X2

Date	Particulars	No.	Dividend Rs.	Amount Rs.	Date	Particulars	No.	Dividend Rs.	Amount Rs.
20X1 April 1	To Balance b/d	15,000	-	2,25,000	20X1 Oct. 31	By Bank A/c (W.N. 5)	-	30,000	10,000
June 1	To Bank A/c	5,000	-	1,00,000	20X2 Jan. 1	By Bank A/c (W.N.4)	13,000	-	2,12,355
July 1	To Bonus Issue (W.N. 1)	4,000	-	-	March 31	By Balance c/d (W.N. 6)	13,000	-	1,69,500
Sept.1	To Bank A/c (W.N. 2)	2,000	-	24,000					
20X2 Jan 1	To P & L A/c (W.N. 4)	-	-	42,855					
"20X2 March 31	To P & L A/c	-	30,000	-					
		26,000	30,000	3,91,855			26,000	30,000	3,91,855

Working Notes:

1. **Calculation of no. of bonus shares issued**

   Bonus Shares = $\frac{15{,}000 \text{ shares} + 5{,}000 \text{ shares}}{5} \times 1 = 4{,}000 \text{ shares}$

2. **Calculation of right shares subscribed**

   Right Shares = $\frac{15{,}000 \text{ shares} + 5{,}000 \text{ shares} + 4{,}000 \text{ shares}}{6} = 4{,}000 \text{ shares}$

   Shares subscribed by XY Ltd. = $\frac{4{,}000}{2} = 2{,}000$ shares

   Value of right shares subscribed = 2,000 shares @ Rs. 12 per share = Rs. 24,000

3. **Calculation of sale of right entitlement**

   2,000 shares x Rs. 8 per share = Rs. 16,000

   Amount received from sale of rights will be credited to statement of profit and loss.

4. **Calculation of profit on sale of shares**

Total holding = 15,000 shares original

5,000 shares purchased

4,000 shares bonus

2,000 shares right shares

26,000 shares

50% of the holdings were sold

i.e. 13,000 shares (26,000 x1/2) were sold.

Cost of total holdings of 26,000 shares (on average basis)

= Rs. 2,25,000 + Rs. 1,00,000 + Rs. 24,000– Rs. 10,000 = Rs. 3,39,000

Average cost of 13,000 shares would be

$$= \frac{3,39,000}{26,000} \times 13,000 = Rs.1,69,500$$

	Rs.
Sale proceeds of 13,000 shares (13,000 x Rs.16.50)	2,14,500
Less: 1% Brokerage	(2,145)
	2,12,355
Less: Cost of 13,000 shares	(1,69,500)
Profit on sale	42,855

SHRESHTA

5. **Dividend received on investment held as on 1st April, 20X1**

= 15,000 shares x Rs. 10 x 20%

= Rs. 30,000 will be transferred to Profit and Loss A/c

Dividend received on shares purchased on 1st June, 20X1

= 5,000 shares x Rs. 10 x 20% = Rs.10,000 will be adjusted to Investment A/c

Note: It is presumed that no dividend is received on bonus shares as bonus shares are declared on 1st July, 20X1 and dividend pertains to the year ended 31.3.20X1.

6. **Calculation of closing value of shares (on average basis) as on 31st March, 20X2**

$$13,000 \times \frac{3,39,000}{26,000} = Rs.1,69,500$$

Q.NO.3. The following information is presented by Mr. Z (a stock broker), relating to his holding in 9% Central Government Bonds.

Opening balance (nominal value) Rs.1,20,000, Cost Rs.1,18,000 (Nominal value of each unit is Rs. 100).

1.3.20X1 Purchased 200 units, ex-interest at Rs. 98.

1.7.20X1 Sold 500 units, ex-interest out of original holding at Rs. 100.

1.10.20X1 Purchased 150 units at Rs. 98, cum interest.

1.11.20X1 Sold 300 units, ex-interest at Rs. 99 out of original holdings.

Interest dates are 30th September and 31st March. Mr. Z closes his books every 31st December. Show the investment account as it would appear in his books. Mr. Z follows FIFO method.

<u>SOLUTION</u>

In the Books of Mr. Z

9% Central Government Bonds (Investment) Account

Particulars		Nominal Value	Interest	Principal	Particulars		Nominal Value	Interest	Principal
20X1		Rs.	Rs.	Rs.	**20X1**		Rs.	Rs.	Rs.
Jan.1	To Balance b/d (W.N.1)	1,20,000	2,700	1,18,000	Mar. 31	By Bank A/c (W.N.3)	-	6,300	-
March 1	To Bank A/c (W.N.2)	20,000	750	19,600	July 1	By Bank A/c (W.N.4)	50,000	1,125	50,000
July 1	To P&L A/c (W.N.5)	-	-	833	Sept. 30	By Bank A/c (W.N.6)	-	4,050	-
Oct. 1	To Bank A/c (150 x 98)	15,000	-	14,700	Nov. 1	By Bank A/c (W.N.7)	30,000	225	29,700
Nov. 1	To P&L A/c (W.N.8)	-	-	200	Dec. 31	By Balance c/d (W.N. 9 & W.N.10)	75,000	1,688	73,633
Dec.31	To P & L A/c (b.f.) (Transfer)		9,938						
		1,55,000	13,388	1,53,333			1,55,000	13,388	1,53,333

Working Note:

1. Interest element in opening balance of bonds = 1,20,000 x 9% x 3/12 = Rs.2,700
2. **Purchase of bonds on 1. 3.20X1**

   Interest element in purchase of bonds = 200 x 100 x 9% x 5/12 = Rs.750

Investment element in purchase of bonds = 200 x 98 = Rs.19,600

3. Interest for half-year ended 31 March = 1,400 x 100 x 9% x 6/12 = Rs.6,300

4. **Sale of bonds on 1.7.20X1**

   Interest element = 500 x 100 x 9% x 3/12 = Rs.1,125

   Investment element = 500 x 100 = Rs.50,000

5. **Profit on sale of bonds on 1.7.20X1**

   Cost of bonds = (1,18,000/ 1,200) x 500 = Rs.49,167

   Sale proceeds = Rs.50,000

   Profit element = Rs.833

6. **Interest for half-year ended 30 September**

   = 900 x 100 x 9% x 6/12 = Rs.4,050

7. **Sale of bonds on 1.11.20X1**

   Interest element = 300 x 100 x 9% x 1/12 = Rs. 225

   Investment element = 300 x 99 = Rs.29,700

8. **Profit on sale of bonds on 1.11.20X1**

   Cost of bonds = (1,18,000/ 1,200) x 300 = Rs.29,500

   Sale proceeds = Rs.29,700

   Profit element = Rs.200

9. **Closing value of investment**

Calculation of closing balance:	**Nominal value**		**Rs.**
Bonds in hand remained in hand at 31st December 20X1			
From original holding (1,20,000 – 50,000 – 30,000) =	40,000	$\frac{1,18,000}{1,20,000} \times 40,000$	39,333
Purchased on 1st March	20,000		19,600
Purchased on 1st October	15,000		14,700
	75,000		**73,633**

10. Interest element in closing balance of bonds = 750 x 100 x 9% x 3/12 = Rs.1,688

Q.NO.4. Mr. Purohit furnishes the following details relating to his holding in 8% Debentures (Rs.100 each) of P Ltd., held as Current assets:

1.4.20X1 Opening balance – Nominal value Rs. 1,20,000, Cost Rs. 1,18,000

1.7.20X1 100 Debentures purchased ex-interest at Rs. 98

SHRESHTA

1.10.20X1 Sold 200 Debentures ex-interest at Rs. 100

1.1.20X2 Purchased 50 Debentures at Rs. 98 ex-interest

1.2.20X2 Sold 200 Debentures ex-interest at Rs.99

Due dates of interest are 30th September and 31st March.

Mr. Purohit closes his books on 31.3.20X2. Brokerage at 1% is to be paid for each transaction (at ex-interest price). Show Investment account as it would appear in his books. Assume FIFO method. Market value of 8% Debentures of P Limited on 31.3.20X2 is Rs. 99.

<u>SOLUTION</u>

Investment A/c of Mr. Purohit

for the year ending on 31-3-20X2

(Scrip: 8% Debentures of P Limited)

(Interest Payable on 30th September and 31st March)

Date	Particulars	Nominal Value	Interest	Cost	Date	Particulars	Nominal Value	Interest	Cost
			Rs.	Rs.				Rs.	Rs.
1.4.20X1	To Balance b/d	1,20,000	-	1,18,000	30.9.20X1	By Bank (1,300 x 100 x 8% x 6/12)	-	5,200	-
1.7.20X1	To Bank (ex-Interest) (W.N.1)	10,000	200	9,898	1.10.20X1	By Bank (W.N.4)	20,000	-	19,800
1.10.20X1	To Profit & Loss A/c (W.N.4)			133	1.2.20X2	By Bank (ex-Interest) (W.N.5)	20,000	533	19,602
1.1.20X2	To Bank (ex-Interest) (W.N.2)	5,000	100	4,949	1.2.20X2	By Profit & Loss A/c (W.N.5)			64
31.3.20X2 (W.N.3)	To Profit & Loss A/c (Bal. fig.)	-	9,233		31.3.20X2	By Bank (950 x 100 x 8% x 6/12)	-	3,800	-
					31.3.20X2	By Balance c/d (W.N.3)	95,000	-	93,514
		1,35,000	**9,533**	**1,32,980**			**1,35,000**	**9,533**	**1,32,980**

SHRESHTA

Working Notes:

1. **Purchase of debentures on 1.7.20X1**

   Interest element = 100 x 100 x 8% x 3/12 = Rs. 200

   Investment element = (100 x 98) + [1% (100 x 98)] = Rs. 9,898

2. **Purchase of debentures on 1.1.20X2**

   Interest element = 50 x 100 x 8% x 3/12 = Rs. 100

   Investment element = {(50 x 98) + [1% (50 x 98)]} = Rs. 4,949

3. **Valuation of closing balance as on 31.3.20X2:**

   Market value of 950 Debentures at Rs. 99 = Rs. 94,050

   Cost of

   800 Debentures cost = $\left(\frac{1{,}18{,}000}{1{,}20{,}000} \times 80{,}000\right)$ = 78,667

   100 Debentures cost = 9,898

   50 Debentures cost = 4,949

   93,514

   Value at the end = Rs. 93,514, i.e., whichever is less

4. **Profit on sale of debentures as on 1.10.20X1**

	Rs.
Sales price of debentures (200 x Rs. 100)	20,000
Less: Brokerage @ 1%	(200)
	19,800
Less: Cost of Debentures = $\left(\frac{1{,}18{,}000}{1{,}20{,}000} \times 20{,}000\right)$	(19,667)
Profit on sale	133

5. **Loss on sale of debentures as on 1.2.20X2**

	Rs.
Sales price of debentures (200 x Rs. 99)	19,800
Less: Brokerage @ 1%	(198)
	19,602
Less: Cost of Debentures = $\left(\frac{1{,}18{,}000}{1{,}20{,}000} \times 20{,}000\right)$	(19,666)
Loss on sale	64
Interest element in sale of investment = 200 x 100 x 8% x 4/12	Rs. 533

SHRESHTA

Q.NO.5. **On 1st April, 20X1, Mr. Vijay had 30,000 Equity shares in X Ltd. at a book value of Rs.4,50,000 (Face Value Rs. 10 per share). On 22nd June, 20X1, he purchased another 5000 shares of the same company for Rs. 80,000.**

The Directors of X Ltd. announced a bonus of equity shares in the ratio of one share for seven shares held on 10th August, 20X1.

On 31st August, 20X1 the Company made a right issue in the ratio of three shares for every eight shares held, on payment of Rs. 15 per share. Due date for the payment was 30th September, 20X1, Mr. Vijay subscribed to 2/3rd of the right shares and sold the remaining of his entitlement to Viru for a consideration of Rs. 2 per share.

On 31st October, 20X1, Vijay received dividends from X Ltd. @ 20% for the year ended 31st March, 20X1. Dividend for the shares acquired by him on 22nd June, 20X1 to be adjusted against the cost of purchase.

On 15th November, 20X1 Vijay sold 20,000 Equity shares at a premium of Rs. 5 per share.

You are required to prepare Investment Account in the books of Mr. Vijay for the year ended 31st March, 20X2 assuming the shares are being valued at average cost.

SOLUTION

Investment Account in Books of Vijay

(Scrip: Equity Shares in X Ltd.)

		No.	**Amount**			**No.**	**Amount**
			Rs.				**Rs.**
1.4.20X1	To Bal b/d	30,000	4,50,000	31.10.20X1	By Bank (dividend on shares acquired on 22.6.20X1)	—	10,000
22.6.20X1	To Bank	5,000	80,000				
10.8.20X1	To Bonus	5,000	_				
30.9.20X1	To Bank (Rights Shares)	10,000	1,50,000				
15.11.20X1	To P&L A/c (Profit on sale of shares)		32,000	15.11.20X1	By Bank (Sale of shares)	20,000	3,00,000
				31.3.20X2	By Bal. c/d	30,000	4,02,000
		50,000	7,12,000			50,000	7,12,000

Working Notes:

1. **Bonus Shares** = (30,000 + 5,000) / 7 = 5,000 shares

2. **Right Shares** = $\left(\frac{30,000+5,000+5,000}{8}\times 3\right)$ = 15,000

3. **Rights shares sold** = 15,000 × 1/3 = 5,000 shares

4. **Dividend received** = 30,000 × 10 × 20% = Rs. 60,000 will be taken to P&L statement

5. **Dividend on shares purchased on 22.6.20X1**

   = 5,000×10×20%

   = Rs. 10,000 is adjusted to Investment A/c

6. **Profit on sale of 20,000 shares**

   = Sales proceeds – Average cost

   Sales proceeds = Rs. 3,00,000

   Average cost = $\frac{(4,50,000 + 80,000 + 1,50,000 - 10,000)}{50,000}\times 20,000$

   = Rs. 2,68,000

   Profit = Rs.3,00,000– Rs.2,68,000= Rs.32,000.

7. **Cost of shares on 31.3.20X2**

   $\frac{(4,50,000 + 80,000 + 1,50,000 - 10,000)}{50,000}\times 30,000 = \text{Rs.}4,02,000$

8. Sale of rights amounting Rs.10,000 (Rs.2 x 5,000 shares) will not be shown in investment A/c but will directly be taken to P & L statement.

SHRESHTA

Q.NO.6. Blue-chip Equity Investments Ltd., wants to re-classify its investments in accordance with AS 13 (Revised). State the values, at which the investments have to be reclassified in the following cases:

i. **Long term investments in Company A, costing Rs.8.5 lakhs are to be reclassified as current. The company had reduced the value of these investments to Rs.6.5 lakhs to recognise 'other than temporary' decline in value. The fair value on date of transfer is Rs.6.8 lakhs.**

ii. **Long term investments in Company B, costing Rs.7 lakhs are to be re-classified as current. The fair value on date of transfer is Rs.8 lakhs and book value is Rs.7 lakhs.**

iii. **Current investment in Company C, costing Rs.10 lakhs are to be reclassified as long term as the company wants to retain them. The market value on date of transfer is Rs.12 lakhs.**

SOLUTION

As per AS 13 (Revised) 'Accounting for Investments', where long-term investments are reclassified as current investments, transfers are made at the lower of cost and carrying amount at the date of transfer. And where investments are reclassified from current to long term, transfers are made at lower of cost and fair value on the date of transfer.

Accordingly, the re-classification will be done on the following basis:

i. In this case, carrying amount of investment on the date of transfer is less than the cost; hence this re-classified current investment should be carried at Rs.6.5 lakhs in the books.

ii. The carrying / book value of the long term investment is same as cost i.e. Rs.7 lakhs. Hence this long term investment will be reclassified as current investment at book value of Rs.7 lakhs only.

iii. In this case, reclassification of current investment into long-term investments will be made at Rs.10 lakhs as cost is less than its market value of Rs.12 lakhs.

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UNIT 4: ACCOUNTING STANDARD 16: BORROWING COSTS

LEARNING OUTCOMES

After studying this unit, you will be able to recognize–

- Meaning of Borrowing costs;
- Definition of Qualifying Asset;
- Accounting treatment for borrowings – Specific and general borrowings;
- Time when does Commencement of Capitalisation takes place;
- Time when does Suspension and cessation of Capitalisation takes place;
- Disclosure requirements for this standard.

4.1 INTRODUCTION

The objective of AS 16 is to prescribe the accounting treatment for borrowing costs. It **does not** deal with the actual or imputed cost of owners' equity, including preference share capital not classified as a liability.

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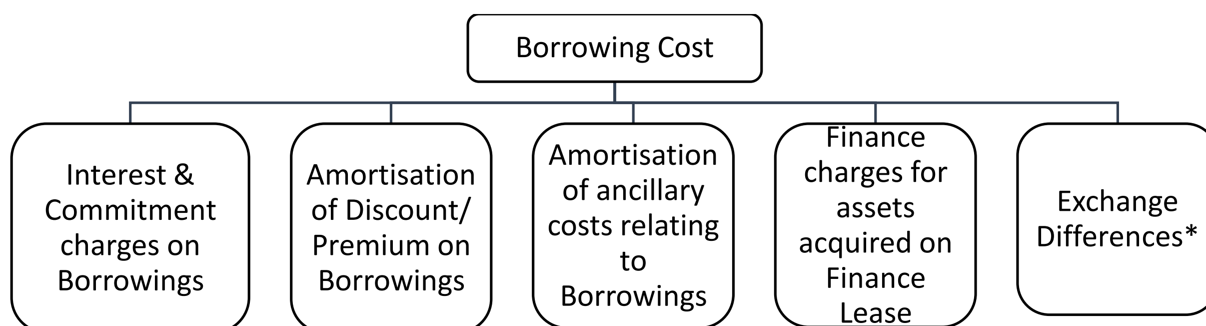
Clarification Chart:

Particulars	Remarks – Is the fund covered by AS 16?
Equity share capital	No
Retained earnings	No
Preference Share Capital classified as a liability Preference	Yes
Share Capital classified as equity	No

4.2 DEFINITIONS

Borrowing costs are interest and other costs incurred by an enterprise in connection with the borrowing of funds.



*To the extent they are regarded as an adjustment to interest cost

A qualifying asset is an asset (Tangible or intangible) that necessarily takes a substantial period of time to get ready for its intended use or sale.

Examples of qualifying assets are manufacturing plants, power generation facilities, inventories that require a substantial period of time to bring them to a saleable condition, and investment properties. Other investments and those inventories that are routinely manufactured or otherwise produced in large quantities on a repetitive basis over a short period of time, are not qualifying assets. Assets that are ready for their intended use or sale when acquired also are not qualifying assets.

Clarification Chart:

Particulars	**Remarks – Is the fund covered by AS 16?**
PPE (Property, plant and equipment)	Yes
Intangible assets	Yes
Investment Properties (Building meant for capital appreciation and earning rental income)	Yes
Inventory	Yes – If they require a substantial period of time to bring them to a saleable condition.
Investments (Financial assets)	No

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Accounting standard further clarifies the meaning of the expression 'substantial period of time'. According to it, substantial period of time primarily depends on the facts and circumstances of each case. It further states that, ordinarily, a period of twelve months is considered as substantial period of time unless a shorter or longer period can be justified on the basis of the facts and circumstances of the case. Therefore, a rebuttable presumption of a period of twelve months is considered "substantial" period of time. In estimating the period, time which an asset takes technologically and commercially to get it ready for its intended use or sale should be considered.

4.3 EXCHANGE DIFFERENCES ON FOREIGN CURRENCY BORROWINGS

Exchange differences arising from foreign currency borrowing and considered as borrowing costs are those exchange differences which arise on the amount of principal of the foreign currency borrowings to the extent of the difference between interest on local currency borrowings and interest on foreign currency borrowings. Thus, the amount of exchange difference not exceeding the

difference between interest on local currency borrowings and interest on foreign currency borrowings is considered as borrowings cost to be accounted for under this Standard and the remaining exchange difference, if any, is accounted for under AS 11, 'The Effect of Changes in Foreign Exchange Rates'. For this purpose, the interest rate for the local currency borrowings is considered as that rate at which the enterprise would have raised the borrowings locally had the enterprise not decided to raise the foreign currency borrowings.

Clarification Chart:

Particulars	**Accounting Treatment**
Exchange Gain	Credited to P&L
Exchange Loss	**Lower** of the following is treated as a part of borrowing costs: **1.** Actual exchange loss; **2.** Difference between interest on local currency borrowings and interest on foreign currency borrowings. **Note:** The excess exchange difference if any will be charged to P&L A/c.

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If the difference between the interest on local currency borrowings and the interest on foreign currency borrowings is equal to or more than the exchange difference on the amount of principal of the foreign currency borrowings, the entire amount of exchange difference is covered under paragraph 4 (e) of AS 16.

If there is exchange gain in the next year, then it will reduce the borrowing cost in that year to the extent exchange loss was earlier treated as borrowing cost for that borrowing.

Example

XYZ Ltd. has taken a loan of USD 10,000 on April 1, 20X1, for a specific project at an interest rate of 5% p.a., payable annually. On April 1, 20X1, the exchange rate between the currencies was Rs. 45 per USD. The exchange rate, as at March 31, 20X2, is Rs. 48 per USD. The corresponding amount could have been borrowed by XYZ Ltd. in local currency at an interest rate of 11 per cent per annum as on April 1, 20X1. The following computation would be made to determine the amount of borrowing costs for the purposes of paragraph 4(e) of AS 16:

i. Interest for the period = USD 10,000 x 5% x Rs. 48/USD = Rs. 24,000

ii. Increase in the liability towards the principal amount = USD 10,000 x (48-45) = Rs. 30,000

iii. Interest that would have resulted if the loan was taken in Indian currency = USD 10,000 x 45 x 11% = Rs. 49,500

iv. Difference between interest on local currency borrowing and foreign currency borrowing = Rs.49,500 – Rs. 24,000 = Rs. 25,500

Therefore, out of Rs. 30,000 increase in the liability towards principal amount, only Rs. 25,500 will be considered as the borrowing cost. Thus, total borrowing cost would be Rs. 49,500 being the aggregate of interest of Rs. 24,000 on foreign currency borrowings (covered by paragraph 4(a) of AS 16) plus the exchange difference to the extent of difference between interest on local currency borrowing and interest on foreign currency borrowing of Rs. 25,500.

Thus, Rs. 49,500 would be considered as the borrowing cost to be accounted for as per AS 16 and the remaining Rs. 4,500 would be considered as the exchange difference to be accounted for as per Accounting Standard (AS) 11, The Effects of Changes in Foreign Exchange Rates.

In the above example, if the interest rate on local currency borrowings is assumed to be 13% instead of 11%, the entire exchange difference of Rs. 30,000 would be considered as borrowing costs, since in that case the difference between the interest on local currency borrowings and foreign currency borrowings [i.e., Rs. 34,500 (Rs. 58,500 – Rs. 24,000)] is more than the exchange difference of Rs.30,000. Therefore, in such a case, the total borrowing cost would be Rs. 54,000 (Rs. 24,000 + Rs.30,000) which would be accounted for under AS 16 and there would be no exchange difference to be accounted for under AS 11 'The Effects of Changes in Foreign Exchange Rates'.

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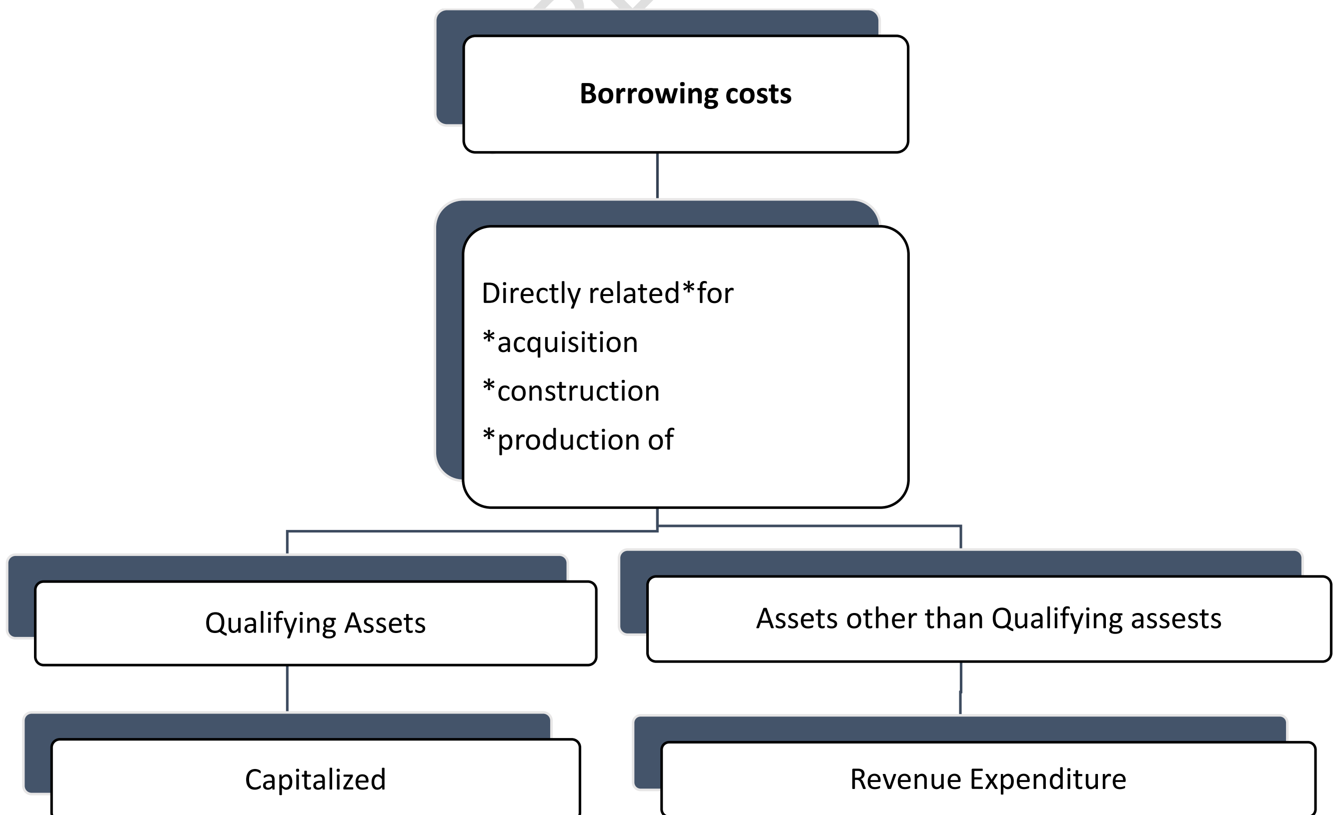
4.4 BORROWING COSTS ELIGIBLE FOR CAPITALISATION

Treatment of Borrowing Costs



*or that could have been avoided if the expenditure on qualifying assets had not been made.

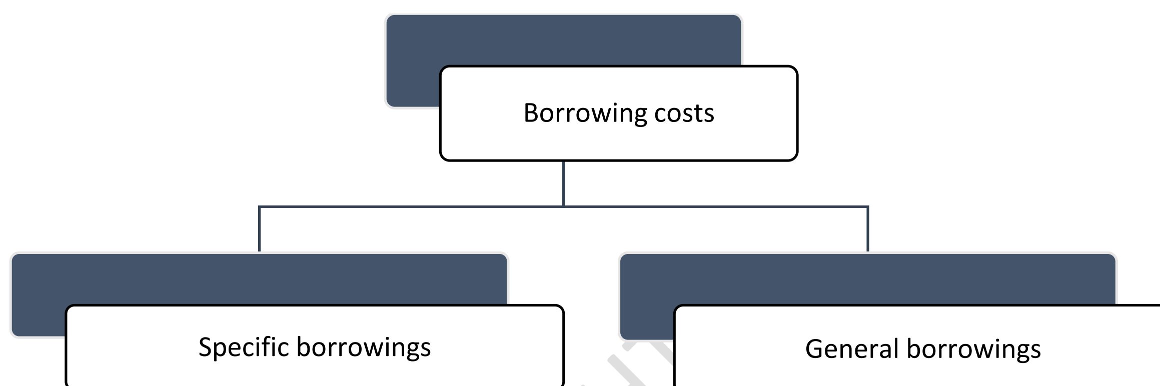
The borrowing costs (including exchange loss treated as borrowing cost as per para 4(e)) that are directly attributable to the acquisition, construction or production of a qualifying asset are those borrowing costs that would have been avoided if the expenditure on the qualifying asset had not been made. Other borrowing costs are recognised as an expense in the period in which they are incurred.

4.5 RECOGNITION CRITERIA

Borrowing costs are capitalised as part of the cost of a qualifying asset when:

a. it is probable that they will result in future economic benefits to the enterprise; and

b. the costs can be measured reliably.



(Refer Illustration 1)

4.6 SPECIFIC BORROWINGS

When an enterprise borrows funds specifically for the purpose of obtaining a particular qualifying asset, the borrowing costs that directly relate to that qualifying asset can be readily identified.

To the extent that funds are borrowed specifically for the purpose of obtaining a qualifying asset, the amount of borrowing costs eligible for capitalisation on that asset should be determined as the actual borrowing costs incurred on that borrowing during the period less any income on the temporary investment of those borrowings.

Amount eligible for capitalisation:

= Actual borrowing costs incurred (-) Any income on the temporary investment of those borrowings

The financing arrangements for a qualifying asset may result in an enterprise obtaining borrowed funds and incurring associated borrowing costs before some or all of the funds are used for expenditure on the qualifying asset. In such circumstances, the funds are often temporarily invested pending their expenditure on the qualifying asset. In determining the amount of borrowing costs eligible for capitalisation during a period, any income earned on the temporary investment of those borrowings is deducted from the borrowing costs incurred.

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4.7 GENERAL BORROWINGS

It may be difficult to identify a direct relationship between particular borrowings and a qualifying asset and to determine the borrowings that could otherwise have been avoided. To the extent that funds are borrowed generally and used for the purpose of obtaining a qualifying asset, the amount of borrowing costs eligible for capitalisation should be determined by applying a capitalisation rate to the expenditure on that asset. The capitalisation rate should be the weighted average of the borrowing costs applicable to the borrowings of the enterprise that are outstanding during the period, other than borrowings made specifically for the purpose of obtaining a qualifying asset. The amount of borrowing costs capitalised during a period should not exceed the amount of borrowing costs incurred during that period.

Step 1 - Compute the capitalisation rate:

Where,

$$\text{Capitalisation Rate} = \frac{\text{Borrowing cost on general borrowings}}{\text{Weighted average of general borrowings outstanding during the period}} \times 100$$

Step 2 - Amount eligible for capitalisation:

= Expenditure incurred on Qualifying asset x Capitalisation rate

Step 3 – Cross check:

The amount of borrowing costs capitalised during a period should not exceed the amount of borrowing costs incurred during that period.

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4.8 EXCESS OF THE CARRYING AMOUNT OF THE QUALIFYING ASSET OVER RECOVERABLE AMOUNT

When the carrying amount or the expected ultimate cost of the qualifying asset exceeds its recoverable amount or net realisable value, the carrying amount is written down or written off in accordance with the requirements of other Accounting Standards. In certain circumstances, the amount of the write-down or write-off is written back in accordance with those other Accounting Standards.

(Refer Illustration 2)

4.9 COMMENCEMENT OF CAPITALISATION

The capitalisation of borrowing costs as part of the cost of a qualifying asset should commence when **all** the following conditions are satisfied:

a. **Expenditure for the acquisition, construction or production of a qualifying asset is being incurred:** Expenditure on a qualifying asset includes only such expenditure that has resulted in payments of cash, transfers of other assets or the assumption of interest-bearing liabilities.

Expenditure is reduced by any progress payments received and grants received in connection with the asset. The average carrying amount of the asset during a period, including borrowing costs previously capitalised, is normally a reasonable approximation of the expenditure to which the capitalisation rate is applied in that period.

b. **Borrowing costs are being incurred.**

c. **Activities that are necessary to prepare the asset for its intended use or sale are in progress:** The activities necessary to prepare the asset for its intended use or sale encompass more than the physical construction of the asset. They include technical and administrative work prior to the commencement of physical construction. However, such activities exclude the holding of an asset when no production or development that changes the asset's condition is taking place. For example, borrowing costs incurred while land is under development are capitalised during the period in which activities related to the development are being undertaken. However, borrowing costs incurred while land acquired for building purposes is held without any associated development activity do not qualify for capitalisation.

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4.10 SUSPENSION OF CAPITALISATION

Capitalisation of borrowing costs should be suspended during extended periods in which active development is interrupted.

Borrowing costs may be incurred during an extended period in which the activities necessary to prepare an asset for its intended use or sale are interrupted. Such costs are costs of holding partially completed assets and do not qualify for capitalisation. However, capitalisation of borrowing costs is not normally suspended during a period when substantial technical and administrative work is being carried out.

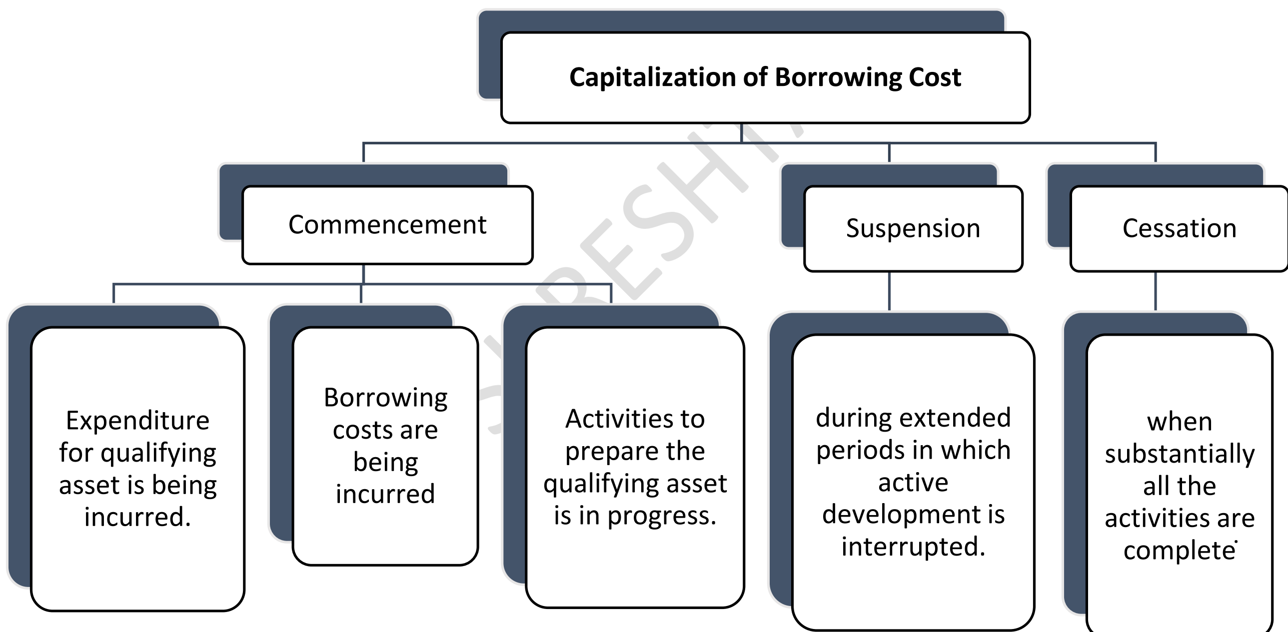
Capitalisation of borrowing costs is also not suspended when a temporary delay is a necessary part of the process of getting an asset ready for its intended use or sale. For example: capitalisation continues during the extended period needed for inventories to mature or the extended period during which high water levels delay construction of a bridge, if such high water levels are common during the construction period in the geographic region involved.

4.11 CESSATION OF CAPITALISATION

Capitalisation of borrowing costs should cease when substantially all the activities necessary to prepare the qualifying asset for its intended use or sale are complete.

An asset is normally ready for its intended use or sale when its physical construction or production is complete even though routine administrative work might still continue. If minor modifications, such as the decoration of a property to the user's specification, are all that are outstanding, this indicates that substantially all the activities are complete.

When the construction of a qualifying asset is completed in parts and a completed part is capable of being used while construction continues for the other parts, capitalisation of borrowing costs in relation to a part should cease when substantially all the activities necessary to prepare that part for its intended use or sale are complete. A business park comprising several buildings, each of which can be used individually, is an example of a qualifying asset for which each part is capable of being used while construction continues for the other parts. An example of a qualifying asset that needs to be complete before any part can be used is an industrial plant involving several processes which are carried out in sequence at different parts of the plant within the same site, such as a steel mill.



4.12 DISCLOSURE

The financial statements should disclose:

a. The accounting policy adopted for borrowing costs; and

b. The amount of borrowing costs capitalised during the period.

(Refer Illustration 3 & 4)

ILLUSTRATIONS

Illustration 1

PRM Ltd. obtained a loan from a bank for Rs. 120 lakhs on 30-04-20X1. It was utilised as follows:

Particulars	Amount (Rs. in lakhs)
Construction of a shed	**50**
Purchase of a machinery	**40**
Working Capital	**20**
Advance for purchase of Truck	**10**

Construction of shed was completed in March 20X2. The machinery was installed on the date of acquisition. Delivery of truck was not received. Total interest charged by the bank for the year ending 31-03-20X2 was Rs. 18 lakhs. Show the treatment of interest.

Solution

Qualifying Asset as per AS 16 = Rs. 50 lakhs (construction of a shed)

Borrowing cost to be capitalised = 18 x 50/120 = Rs. 7.5 lakhs

Interest to be debited to Profit or Loss account = Rs. (18 – 7.5) lakhs = Rs. 10.5 lakhs

Illustration 2

X Ltd. began construction of a new building on 1st January, 20X1. It obtained Rs. 1 lakh special loan to finance the construction of the building on 1st January, 20X1 at an interest rate of 10%. The company's other outstanding two non-specific loans were:

Amount	Rate of Interest
Rs. 5,00,000	**11%**
Rs. 9,00,000	**13%**

The expenditures that were made on the building project were as follows:

		Rs.
January	**20X1**	**2,00,000**
April	**20X1**	**2,50,000**
July	**20X1**	**4,50,000**
December	**20X1**	**1,20,000**

Building was completed by 31st December 20X1. Following the principles prescribed in AS 16 'Borrowing Cost,' calculate the amount of interest to be capitalised and pass one Journal Entry for capitalising the cost and borrowing cost in respect of the building.

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Solution

i. Computation of weighted average accumulated expenses

		Rs.
Rs. 2,00,000 x 12 / 12	=	2,00,000
Rs. 2,50,000 x 9 / 12	=	1,87,500
Rs. 4,50,000 x 6 / 12	=	2,25,000
Rs. 1,20,000 x 1 / 12	=	10,000
		6,22,500

ii. Calculation of weighted average interest rate other than for specific borrowings

Amount of loan (Rs.)	Rate of interest	Amount of interest (Rs.)
5,00,000	11%	= 55,000
9,00,000	13%	= 1,17,000
14,00,000		1,72,000
Weighted average rate of interest $\left(\frac{1,72,000}{14,00,000}\times 100\right)$		= 12.285% (approx.)

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iii. Interest on weighted average accumulated expenses

		Rs.
Specific borrowings (Rs.1,00,000 x 10%)	=	10,000
Non-specific borrowings (Rs.5,22,500* x 12.285%)	=	64,189
Amount of interest to be capitalised	=	74,189

iv. Total expenses to be capitalized for building

	Rs.
Cost of building Rs. (2,00,000 + 2,50,000 + 4,50,000 + 1,20,000)	10,20,000
Add: Amount of interest to be capitalised	74,189
	10,94,189

v. Journal Entry

Date	Particulars		Dr. (Rs.)	Cr. (Rs.)
31.12. 20X1	Building account	Dr.	10,94,189	
	To Bank account			10,94,189
	(Being amount of cost of building and borrowing cost thereon capitalised)			

Illustration 3

The company has obtained Institutional Term Loan of Rs. 580 lakhs for modernisation and renovation of its Plant & Machinery. Plant & Machinery acquired under the modernisation scheme and installation completed on 31st March, 20X2 amounted to Rs. 406 lakhs, Rs. 58 lakhs has been advanced to suppliers for additional assets and the balance loan of Rs. 116 lakhs has been utilised for working capital purpose. The Accountant is on a dilemma as to how to account for the total interest of Rs. 52.20 lakhs incurred during 20X1-20X2 on the entire Institutional Term Loan of Rs.580 lakhs.

Solution

As per para 6 of AS 16 'Borrowing Costs', borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset should be capitalised as part of the cost of that asset. Other borrowing costs should be recognised as an expense in the period in which they are incurred.

A qualifying asset is an asset that necessary takes a substantial period of time* to get ready for its intended use or sale.

The treatment for total interest amount of Rs. 52.20 lakhs can be given as:

Purpose	Nature	Interest to be capitalised	Interest to be charged to profit and loss account
		Rs. in lakhs	Rs.in lakhs
Modernisation and renovation of plant and machinery	Qualifying asset	$**52.20 \times \frac{406}{580} = 36.54$	
Advance to supplies for additional assets	Qualifying asset	$**52.20 \times \frac{58}{580} = 5.22$	
Working Capital	Not a qualifying asset		$**52.20 \times \frac{116}{580} = 10.44$
		41.76	10.44

* A substantial period of time primarily depends on the facts and circumstances of each case. However, ordinarily, a period of twelve months is considered as substantial period of time unless a shorter or longer period can be justified on the basis of the facts and circumstances of the case.

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** It is assumed in the above solution that the modernisation and renovation of plant and machinery will take substantial period of time (i.e. more than twelve months). Regarding purchase of additional assets, the nature of additional assets has also been considered as qualifying assets. Alternatively, the plant and machinery and additional assets may be assumed to be non-qualifying assets on the basis that the renovation and installation of additional assets will not take substantial period of time. In that case, the entire amount of interest, Rs. 52.20 lakhs will be recognised as expense in the profit and loss account for year ended 31st March, 20X2.

Illustration 4

Take Ltd. has borrowed Rs. 30 lakhs from State Bank of India during the financial year 20X1-20X2. The borrowings are used to invest in shares of Give Ltd., a subsidiary company of Take Ltd., which is implementing a new project, estimated to cost Rs. 50 lakhs. As on 31st March, 20X2, since the said project was not complete, the directors of Take Ltd. resolved to capitalise the interest accruing on borrowings amounting to Rs. 4 lakhs and add it to the cost of investments. Comment.

Solution

As per AS 13 (Revised) "Accounting for Investments", the cost of investment includes acquisition charges such as brokerage, fees and duties. In the present case, Take Ltd. has used borrowed funds for purchasing shares of its subsidiary company Give Ltd. Rs. 4 lakhs interest payable by Take Ltd. to State Bank of India cannot be called as acquisition charges, therefore, cannot be constituted as cost of investment.

Further, as per para 3 of AS 16 "Borrowing Costs", a qualifying asset is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale. Since, shares are ready for its intended use at the time of sale, it cannot be considered as qualifying asset that can enable a company to add the borrowing cost to investments. Therefore, the directors of Take Ltd. cannot capitalise the borrowing cost as part of cost of investment. Rather, it has to be charged to the Statement of Profit and Loss for the year ended 31st March, 20X2.

Reference: The students are advised to refer the full text of AS 16 “Borrowing Costs” (issued 2000).

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TEST YOUR KNOWLEDGE

MCQs

1. **As per AS 16, all the following are qualifying assets except**
   a. **Manufacturing plants and Power generation facilities**
   b. **Inventories that require substantial period of time**
   c. **Assets those are ready for sale.**
   d. **None of the above**

2. **Which of the following statement is correct:**
   a. **Entire exchange gain is reduced from the cost of the Qualifying asset.**
   b. **Entire exchange loss is added to the cost of a Qualifying asset.**
   c. **No adjustment is done for the exchange loss while computing cost of Qualifying asset.**
   d. **None of the above**

3. **Capitalisation rate considers:**
   a. **Borrowing costs on general borrowings only.**
   b. **Borrowing costs on general and specific borrowings both.**
   c. **Borrowing costs on specific borrowings only**
   d. **None of the above**

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

5. **X Ltd is commencing a new construction project, which is to be financed by borrowing. The key dates are as follows:**
   i. **15th May, 20X1: Loan interest relating to the project starts to be incurred**
   ii. **2nd June, 20X1: Technical site planning commences**
   iii. **19th June, 20X1: Expenditure on the project started to be incurred**
   iv. **18th July, 20X1: Construction work commences**

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Identify the commencement date for capitalisation under AS 16.

a. **15th May, 20X1.**

b. **19th June, 20X1.**

c. **18th July, 20X1.**

d. **2nd June, 20X1.**

ANSWERS/SOLUTIONS

MCQs

1.	**c.**	Assets those are ready for sale.
2.	**c.**	No adjustment is done for the exchange loss while computing cost of Qualifying asset.
3.	**a.**	Borrowing costs on general borrowings only.
4.	**b.**	Rs.5,000.
5.	**b.**	19th June, 20X1.

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THEORY QUESTIONS

Q.NO.1. When capitalization of borrowing cost should cease as per Accounting Standard 16? Explain the provision.

ANSWER

Capitalization of borrowing costs should cease when substantially all the activities necessary to prepare the qualifying asset for its intended use or sale are complete. An asset is normally ready for its intended use or sale when its physical construction or production is complete even though routine administrative work might still continue. If minor modifications such as the decoration of a property to the user's specification, are all that are outstanding, this indicates that substantially all the activities are complete. When the construction of a qualifying asset is completed in parts and a completed part is capable of being used while construction continues for the other parts, capitalisation of borrowing costs in relation to a part should cease when substantially all the activities necessary to prepare that part for its intended use or sale are complete.

Q.NO.2. H Ltd. incurs borrowing costs for the purpose of construction of a qualifying asset for its own use. The construction gets completed on May 31, 20X1. However, decoration work is under process which is expected to be completed by November 20X1 after which H Ltd. will be able to start using the said asset for its own use. H Ltd. wants to capitalize the eligible borrowing costs incurred up to November 20X1.

ANSWER

The capitalization of borrowing costs shall cease when substantially all the activities necessary to prepare the qualifying assets for its intended use or sale is completed.

In the given case, H Ltd. should capitalize borrowing costs only up to May 31, 20X1. The borrowing cost incurred thereafter cannot be capitalized as the asset was ready for its intended use on May 31, 20X1. The fact that decoration work was being carried out should not be considered as the asset was ready for its intended use on May 31, 20X1.

Q.NO.3. ABC Ltd. is in the process of getting an entertainment park constructed. For this purpose, it has taken loan from a bank. The said park consists of several rides and facilities, each of which can be used individually. Three fourth part of the park has been constructed and can be opened up for public, while construction on the remaining part is continuing. Whether the capitalization of borrowing cost should continue for the whole park until construction continues?

ANSWER

ABC Ltd. is in process of constructing an entertainment park which consists of several rides and facilities that can operate independently for their intended use. Even though the park as whole is not complete, the individual facilities are ready for their intended use.

The cessation of capitalization depends upon the nature of the qualifying assets, particularly where the qualifying assets consists of various parts. There are qualifying assets where each part is capable of being used while the construction continues on other parts. There are qualifying assets where all parts have to be completed before any earlier completed part can be put to use.

Since in the given scenario, the individual facilities are capable of operating independently and are ready for their intended use, therefore the borrowing costs shall cease to be capitalized for the three-fourth part of the project.

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PRACTICAL QUESTIONS

Q.NO.1. On 1st April, 20X1, Amazing Construction Ltd. obtained a loan of Rs. 32 crores to be utilised as under:

i. Construction of sea link across two cities: (work was held up totally for a month during the year due to high water levels) : Rs. 25 crores

ii. Purchase of equipments and machineries : Rs. 3 crores

iii. Working capital : Rs. 2 crores

iv. Purchase of vehicles : Rs. 50,00,000

v. Advance for tools/cranes etc. : Rs. 50,00,000

vi. Purchase of technical know-how : Rs. 1 crores

vii. Total interest charged by the bank for the year ending 31st March, 20X2 : Rs. 80,00,000

Show the treatment of interest by Amazing Construction Ltd.

SOLUTION

According to AS 16 'Borrowing costs', qualifying asset is an asset that necessarily takes substantial period of time to get ready for its intended use.

Borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset should be capitalised as part of the cost of that asset. Other borrowing costs should be recognised as an expense in the period in which they are incurred.

The treatment of interest by Amazing Construction Ltd. can be shown as:

	Qualifying Asset	Interest to be capitalised Rs.	Interest to be charged to Profit & Loss A/c Rs.	
Construction of sea-link	Yes	62,50,000		[80,00,000x (25/32)]
Purchase of equipment and machineries	No		7,50,000	[80,00,000x (3/32)]
Working capital	No		5,00,000	[80,00,000x (2/32)]
Purchase of vehicles	No		1,25,000	[80,00,000x(0.5/32)]
Advance for tools, cranes etc.	No		1,25,000	[80,00,000x(0.5/32)]
Purchase of technical know-how	No		2,50,000	[80,00,000x(1/32)]
Total		62,50,000	17,50,000	

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*It is assumed that work held up for a month due to high water level is normal during the construction of sea link and capitalization of borrowing cost should not be suspended for necessary temporary delay.

Q.NO.2. Rainbow Limited borrowed an amount of Rs.150 crores on 1.4.20X1 for construction of boiler plant @ 11% p.a. The plant is expected to be completed in 4 years. Since the weighted average cost of capital is 13% p.a., the accountant of Rainbow Ltd. capitalized Rs.19.50 crores for the accounting period ending on 31.3.20X2. Due to surplus fund out of Rs.150 crores, income of Rs.3.50 crores were earned and credited to profit and loss account. Comment on the above treatment of accountant with reference to relevant accounting standard.

SOLUTION

Para 10 of AS 16 'Borrowing Costs' states "To the extent that funds are borrowed specifically for the purpose of obtaining a qualifying asset, the amount of borrowing costs eligible for capitalization on that asset should be determined as the actual borrowing costs incurred on that borrowing during the period less any income on the temporary investment of those borrowings."

The capitalization rate should be the weighted average of the borrowing costs applicable to the borrowings of the enterprise that are outstanding during the period, other than borrowings made specifically for the purpose of obtaining a qualifying asset.

Thus, the treatment of accountant of Rainbow Ltd. is incorrect.

Amount of borrowing costs capitalized should be calculated as follows:

Particulars	Rs. in crores
Actual interest for 20X1-20X2 (11% of Rs.150 crores)	16.50
Less: Income on temporary investment from specific borrowings	(3.50)
Borrowing costs to be capitalized during year 20X1-20X2	13.00

Q.NO.3. Harish Construction Company is constructing a huge building project consisting of four phases. It is expected that the full building will be constructed over several years but Phase I and Phase II of the building will be started as soon as they are completed.

Following is the detail of the work done on different phases of the building during the current year: (Rs. in lakhs)

	Phase I Rs.	Phase II Rs.	Phase III Rs.	Phase IV Rs.
Cash expenditure	**10**	**30**	**25**	**30**
Building purchased	**24**	**34**	**30**	**38**

Total expenditure	34	64	55	68
Total expenditure of all phases				221
Loan taken @ 15% at the beginning of the year				200

During mid of the current year, Phase I and Phase II have become operational. Find out the total amount to be capitalized and to be expensed during the year.

SOLUTION

Computation of amount to be capitalized

No.	Particulars	Rs.
1.	Interest expense on loan Rs.2,00,00,000 at 15%	30,00,000
2.	Total cost of Phases I and II (Rs.34,00,000 +64,00,000)	98,00,000
3.	Total cost of Phases III and IV (Rs.55,00,000 + Rs.68,00,000)	1,23,00,000
4.	Total cost of all 4 phases	2,21,00,000
5.	Total loan	2,00,00,000
6.	Interest on loan used for Phases I & II, based on proportionate Loan amount = $= \frac{30,00,000}{2,21,00,000} \times 98,00,000$	3,30,317 (approx.)
7.	Interest on loan used for Phases III & IV, based on proportionate Loan amount = $= \frac{30,00,000}{2,21,00,000} \times 1,23,00,000$	16,69,683 (approx.)

Accounting treatment

For Phase I and Phase II

Since Phase I and Phase II have become operational at the mid of the year, half of the interest amount of Rs. 6,65,158.50 (i.e. Rs.13,30,317/2) relating to Phase I and Phase II should be capitalized (in the ratio of asset costs 34:64) and added to respective assets in Phase I and Phase II and remaining half of the interest amount of Rs.6,65,158.50 (i.e. Rs.13,30,317/2) relating to Phase I and Phase II should be expensed during the year.

For Phase III and Phase IV

Interest of Rs.16,69,683 relating to Phase III and Phase IV should be held in Capital Work-in-Progress till assets construction work is completed, and thereafter capitalized in the ratio of cost of assets. No part of this interest amount should be charged/expensed off during the year since the work on these phases has not been completed yet.

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UNIT 5: ACCOUNTING STANDARD 19: LEASES

LEARNING OUTCOMES

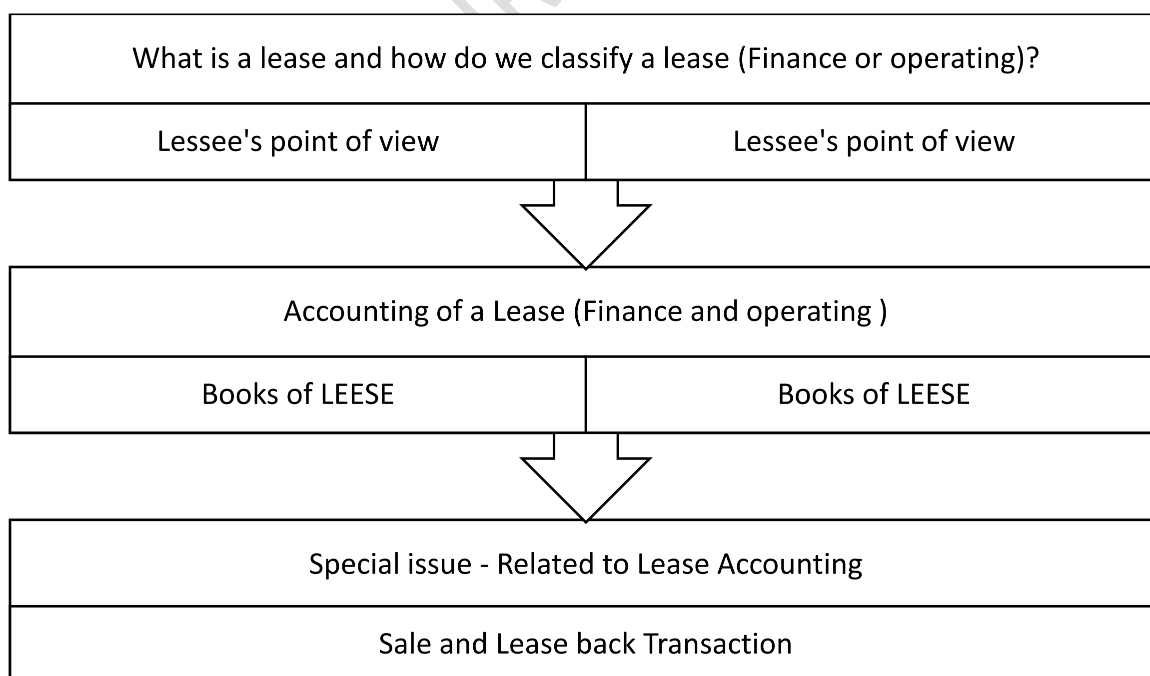
After studying this unit, you will be able to comprehend–

- What is a lease
- What are the parameters for Classification of Leases
- Accounting for leases in the Financial Statements of Lessees
  - Finance Leases
  - Operating Leases
- Accounting for Leases in the Financial Statements of Lessors
  - Finance Leases
  - Operating Leases
- Sale And Leaseback Transactions
- Disclosures required as per the standard

5.1 INTRODUCTION

Before, we start with the standard, let us lay down the coverage of AS 19 from the examination point of view as under:

Areas covered by AS 19:



The objective of AS 19 is to prescribe, for lessees and lessors, the appropriate accounting policies and disclosures in relation to finance leases and operating leases.

What is a Lease?

A Lease is an **agreement** whereby the Lessor (legal owner of an asset) conveys to the Lessee (another party) in return **for a payment** or series of periodic payments (Lease rents), the right to use an asset for an **agreed period of time.**

5.2 APPLICABILITY OF AS 19 [SCOPE]

The standard applies to all leases other than:

a. Lease agreements to explore for or use of natural resources, such as oil, gas, timber metals and other mineral rights; and

b. Licensing agreements for items such as motion picture films, video recordings, plays, manuscripts, patents and copyrights; and

c. Lease agreements to use lands

5.3 DEFINITIONS

A non-cancellable lease is a lease that is cancellable only:

a. upon the occurrence of some remote contingency; or

b. with the permission of the lessor; or

c. if the lessee enters into a new lease for the same or an equivalent asset with the same lessor; or

d. upon payment by the lessee of an additional amount such that, at inception, continuation of the lease is reasonably certain.

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The **lease term** is the non-cancellable period for which the lessee has agreed to take on lease the asset together with any further periods for which the lessee has the option to continue the lease of the asset, with or without further payment, which option at the inception of the lease it is reasonably certain that the lessee will exercise.

The **inception of the lease** is the earlier of the date of the lease agreement and the date of a commitment by the parties to the principal provisions of the lease.

Minimum lease payments are the payments over the lease term that the lessee is, or can be required, to make excluding contingent rent, costs for services and taxes to be paid by and reimbursed to the lessor, together with:

a. In the case of the lessee, any residual value guaranteed by or on behalf of the lessee; or

b. In the case of the lessor, any residual value guaranteed to the lessor:

  i. by or on behalf of the lessee; or

  ii. by an independent third party financially capable of meeting this guarantee.

However, if the lessee has an option to purchase the asset at a price which is expected to be sufficiently lower than the fair value at the date the option becomes exercisable that, at the inception of the lease, is

reasonably certain to be exercised, the minimum lease payments comprise minimum payments payable over the lease term and the payment required to exercise this purchase option.

The above definition can be summarized as under:

Note: The definition can be seen separately from the point of view of Lessee and Lessor.

From the point of view of Lessee	
Case I – Lessee will return the asset at the end of the lease term	Case II – Lessee will retain the asset at the end of the lease term (as he has option to buy the asset and it is reasonably certain that he will exercise the option)
Payments over the lease term that the lessee is, or can be required, to make excluding: **a.** contingent rent. **b.** costs for services and taxes to be paid by and reimbursed to the lessor. + Any residual value guaranteed by or on behalf of the lessee.	Payments over the lease term that the lessee is, or can be required, to make excluding: **a.** contingent rent. **b.** costs for services and taxes to be paid by and reimbursed to the lessor. + Payment required to exercise the purchase option.

From the point of view of Lessee	
Case I – Lessee will return the asset at the end of the lease term Payments over the lease term that the lessee is, or can be required, to make excluding: **a.** contingent rent. **b.** costs for services and taxes to be paid by and reimbursed to the lessor. + Any residual value guaranteed: **a.** by or on behalf of the lessee; or **b.** by an independent third party financially capable of meeting this guarantee.	Case II – **Lessee will retain the asset at the end of the lease term** (as he has option to buy the asset and it is reasonably certain that he will exercise the option) Payments over the lease term that the lessee is, or can be required, to make excluding: **a.** contingent rent. **b.** costs for services and taxes to be paid by and reimbursed to the lessor. + Payment required to exercise the purchase option.

Fair value is the amount for which an asset could be exchanged or a liability settled between knowledgeable, willing parties in an arm's length transaction.

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Economic life is either:

a. the period over which an asset is expected to be economically usable by one or more users; or

b. the number of production or similar units expected to be obtained from the asset by one or more users.

Useful life of a leased asset is either:

a. the period over which the leased asset is expected to be used by the lessee; or

b. the number of production or similar units expected to be obtained from the use of the asset by the lessee.

Note: The economic life is always greater than the useful life of the asset. Useful life represents the depreciable life of an asset whereas, economic life represents the total life during which an asset is capable of generating economic benefits.

Residual value of a leased asset is the estimated fair value of the asset at the end of the lease term.

Guaranteed residual value is:

a. in the case of the lessee, that part of the residual value which is guaranteed by the lessee or by a party on behalf of the lessee (the amount of the guarantee being the maximum amount that could, in any event, become payable); and

b. in the case of the lessor, that part of the residual value which is guaranteed by or on behalf of the lessee, or by an independent third party who is financially capable of discharging the obligations under the guarantee.

Unguaranteed residual value of a leased asset is the amount by which the residual value of the asset exceeds its guaranteed residual value.

Note: Residual value = Guaranteed Residual value (GRV) + Unguaranteed Residual value (UGRV)

Gross investment in the lease is the aggregate of the minimum lease payments under a finance lease from the standpoint of the lessor and any unguaranteed residual value accruing to the lessor.

In simple words,

Gross Investment (GI)	**Undiscounted total cash inflows from the point of view of the lessor**
	Undiscounted total of: **a.** Minimum Lease Payments (MLP); and **b.** Unguaranteed Residual Value (UGRV). Undiscounted total of: **a.** Lease Payments; **b.** Guaranteed residual value (GRV); and

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	c. Unguaranteed Residual value (UGRV). Undiscounted total of: **a.** Lease Payments; and **b.** Residual value (GRV and UGRV);

Unearned finance income is the difference between:

a. the gross investment in the lease; and

b. the present value of

  i. the minimum lease payments under a finance lease from the standpoint of the lessor; and

  ii. any unguaranteed residual value accruing to the lessor,

at the interest rate implicit in the lease.

Unearned Finance Income (UFI)	Gross Investment (GI) – Net Investment (NI)
	Gross Investment (GI) – Present value of Gross Investment Gross Investment – Fair Value Simply speaking = Total Interest

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Net investment in the lease is the gross investment in the lease less unearned finance income.

In simple words,

Net Investment (NI)	**Discounted total cash inflows from the point of view of the lessor**
	Discounted total of: **a.** Minimum Lease Payments (MLP); and **b.** Unguaranteed Residual Value (UGRV). Discounted total of: **a.** Lease Payments; **b.** Guaranteed residual value (GRV); and **c.** Unguaranteed Residual value (UGRV). Discounted total of: **a.** Lease Payments; and **b.** Residual value (GRV and UGRV); Discounted Gross Investment (GI) i.e. Present value of GI Simply speaking = Fair value

The interest rate implicit in the lease is the discount rate that, at the inception of the lease, causes the aggregate present value of

a. the minimum lease payments under a finance lease from the standpoint of the lessor; and

b. any unguaranteed residual value accruing to the lessor, to be equal to the fair value of the leased asset.

Interest rate implicit in the lease	Discount rate at which: Cash Outflows = Present value of Cash Inflows Where, Cash Outflow = Fair value of the asset; Cash Inflow = Lease Payments + Residual Value (GRV and UGRV)
	Simply speaking = Lessor's IRR

The **lessee's incremental borrowing rate of interest** is the rate of interest the lessee would have to pay on a similar lease or, if that is not determinable, the rate that, at the inception of the lease, the lessee would incur to borrow over a similar term, and with a similar security, the funds necessary to purchase the asset.

Contingent rent is that portion of the lease payments that is not fixed in amount but is based on a factor other than just the passage of time (e.g., percentage of sales, amount of usage, price indices, market rates of interest).

The definition of a lease includes agreements for the hire of an asset which contain a provision giving the hirer an option to acquire title to the asset upon the fulfilment of agreed conditions. These agreements are commonly known as hire purchase agreements. Hire purchase agreements include agreements under which the property in the asset is to pass to the hirer on the payment of the last instalment and the hirer has a right to terminate the agreement at any time before the property so passes.

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5.4 TYPES OF LEASES

For accounting purposes, leases are classified as:

i. Finance leases; and
ii. Operating leases.

Finance lease - A lease classified as Finance Lease if it transfers substantially all the risks and rewards incident to ownership of an asset. Title may or may not be eventually transferred.

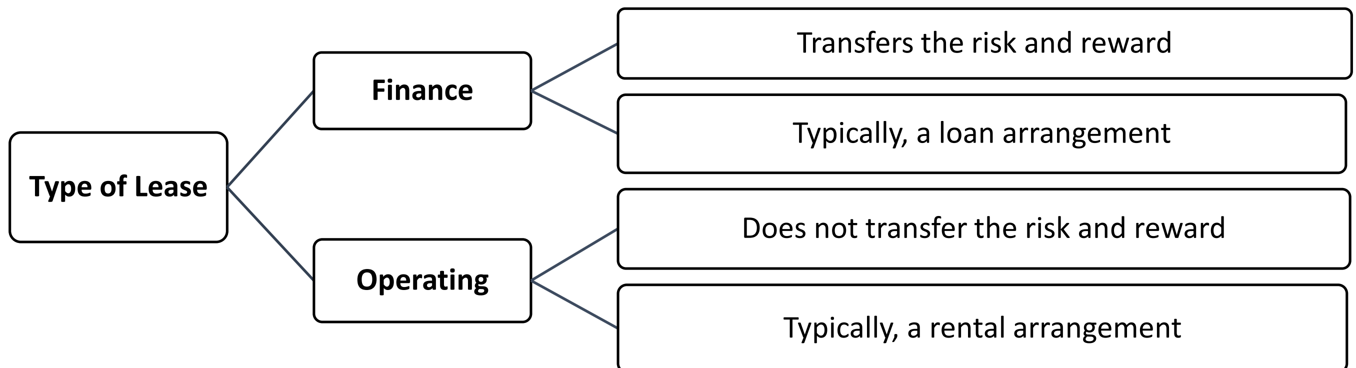
Operating Lease -A lease is classified as an Operating Lease if it does not transfer substantially all the risk and rewards incident to ownership.

Whether a lease is a finance lease or an operating lease depends on the substance of the transaction rather than its form.

Risks include the possibilities of losses from idle capacity or technological obsolescence and of variations in return due to changing economic conditions.

Rewards may be represented by the expectation of profitable operation over the economic life of the asset and of gain from appreciation in value or realisation of residual value.

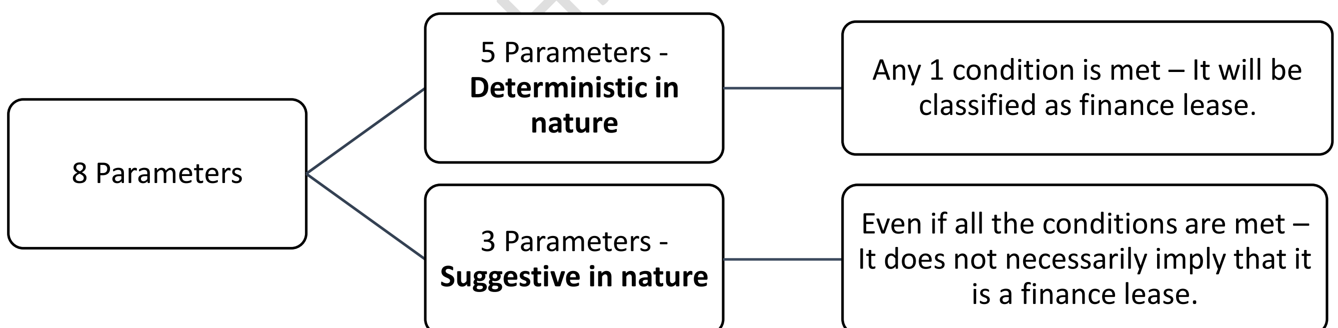
We can summarize the types of lease conceptually as under:



5.5 INDICATORS OF FINANCE LEASE

AS 19 has given a total of 8 parameters to decide whether it is a finance lease or not. (These parameters have been discussed in para 5.6 and 5.7.

These 8 conditions can be divided into following categories:



Let us take up these conditions one by one;

5.6 DETERMINISTIC CONDITIONS

Situations, which would normally lead to a lease being classified as a finance lease are:

a. The lease transfers ownership of the asset to the lessee by the end of the lease term;

b. The lessee has the option to purchase the asset at a price which is expected to be sufficiently lower than the fair value at the date the option becomes exercisable such that, at the inception of the lease, it is reasonably certain that the option will be exercised;

Example

Mr. A has taken a car on lease for 5 years from XYZ. After 5 years of lease term Mr. A has the option to purchase this car for Rs.20,000, whereas it is assumed the car market value at the end of 5th year would be Rs.2,00,000. Considering the option to buy it at bargain price, it is reasonably certain that Mr. A would exercise that option.

c. The lease term is for the major part of the economic life of the asset even if title is not transferred;

Example

XYZ has taken a property on lease for 32 years from ABC, expected economic life of the property is 40 years. Since XYZ is going to use the asset over major part of its economic life (80% in this case), it will meet the condition to be treated as finance lease.

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

e. The leased asset is of a specialized nature such that only the lessee can use it without major modifications being made.

Example

PQR, a hospital ordered 10 ambulances, specially designed as per the requirement of PQR. These ambulances are taken on lease and it cannot be used by anyone else without major modifications. This would meet the condition of finance lease.

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5.7 SUGGESTIVE CONDITIONS

Additional Indicators of situations which individually or in combination could also lead to a lease being classified as a finance lease are:

a. If the lessee can cancel the lease and the lessor's losses associated with the cancellation are borne by the lessee;

b. If gains or losses from the fluctuations in the residual value accrue to the lessee (for example if the lessor agrees to allow rent rebate equalling most of the disposal value of leased asset at the end of the lease); and

c. If the lessee can continue the lease for a secondary period at a rent, which is substantially lower than market rent.

Lease classification is made at the inception of the lease. If at any time the lessee and the lessor agree to change the provisions of the lease, other than by renewing the lease, in a manner that would have resulted in a different classification of the lease had the changed terms been in effect at the inception of the lease, the revised agreement is considered as a new agreement over its revised term.

Changes in estimates (for example, changes in estimates of the economic life or of the residual value of the leased asset) or changes in circumstances (for example, default by the lessee), however, do not give rise to a new classification of a lease for accounting purposes.

5.8 ACCOUNTING FOR FINANCE LEASES (BOOKS OF LESSEE)

Following is the accounting treatment of Finance Leases in the books of Lessee:

i. On the date of inception of Lease, Lessee should show it as an asset and corresponding liability at lower of:

- Fair value of leased asset at the inception of the lease
- Present value of minimum lease payments from the standpoint of the lessee
  (Present value to be calculated with discount rate equal to interest rate implicit in the lease, if this is practicable to determine; if not, the lessee's incremental borrowing rate should be used).

Thus, the journal entry at inception will be as under:

Particulars	Debit	Credit
Asset	Refer Note	
To Lessor (Lease Liability)		Refer Note

It is not appropriate to present the liability for a leased asset as a deduction from the leased asset in the financial statements. The liability for a leased asset should be presented separately in the balance sheet as a current liability or a long-term liability as the case may be.

Note:

The amount will be lower of the two:

a. Fair value.

b. Present value of MLP (Minimum Lease payments) from the point of view of lessee.

ii. Lease payments to be apportioned between the finance charge and the reduction of the outstanding liability.

iii. Finance charges to be allocated to periods during the lease term so as to produce a constant rate of interest on the remaining balance of liability for each period.

iv. A finance lease gives rise to a depreciation expense for the asset as well as a finance expense for each accounting period. The depreciation policy for a leased asset should be consistent with that for depreciable assets which are owned, and the depreciation recognised should be calculated on the basis set out in AS 10 (Revised), Property, Plant and Equipment.

v. If there is no reasonable certainty that the lessee will obtain ownership by the end of the lease term, the asset should be fully depreciated over the lease term or its useful life, whichever is shorter.

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Note:

Cases	Useful life for Depreciation
Case I – Asset will be retained by the lessee	Useful life
Case II – Asset will be returned to the lessor	Useful life or lease term whichever is shorter

vi. Initial direct costs are often incurred in connection with specific leasing activities, as in negotiating and securing leasing arrangements. The costs identified as directly attributable to activities performed by the lessee for a finance lease are included as part of the amount recognised as an asset under the lease.

5.8.1 Computation of interest rate implicit on lease

The interest rate implicit in the lease is the discount rate that, at the inception of the lease, causes the aggregate present value of:

a. the minimum lease payments under a finance lease from the standpoint of the lessor; and

b. any unguaranteed residual value accruing to the lessor, to be equal to the fair value of the leased asset.

Discounting rate = R% p.a;

Lease Rents = L1, L2 ……… Ln (Payable annually, at the end of each year)

Lease period = n years;

Guaranteed residual value = GR;

Unguaranteed residual value = UGR

Fair Value at the inception (beginning) of lease = FV

$$\text{PV of MLP} = \frac{L_1}{(1+R)1} + \frac{L_2}{(1+R)2} + \frac{L_3}{(1+R)n} + \frac{GR}{(1+R)n}$$

$$\text{Present value of unguaranteed residual value} = \frac{UGR}{(1+R)n}$$

If interest rate implicit on lease is used as discounting rate:

Fair Value = PV of Minimum Lease Payments + PV of unguaranteed residual value ….. (1)

The interest rate implicit on lease can be computed by trial and error, provided the information required, e.g. the unguaranteed residual value can be reasonably ascertained.

Example 1

Annual lease rents = Rs.50,000 at the end of each year.

Lease period = 5 years;

Guaranteed residual value = Rs.25,000

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Unguaranteed residual value (UGR) = Rs.15,000

Fair Value at the inception (beginning) of lease = Rs.2,00,000

Interest rate implicit on lease is computed below:

Interest rate implicit on lease is a discounting rate at which present value of minimum lease payments and unguaranteed residual value is Rs.2 lakhs.

PV of minimum lease payments and unguaranteed residual value at guessed rate 10%

Year	**MLP + UGR Rs.**	**DF (10%)**	**PV Rs.**
1	50,000	0.909	45,450
2	50,000	0.826	41,300
3	50,000	0.751	37,550
4	50,000	0.683	34,150
5	50,000	0.621	31,050
5	25,000	0.621	15,525
5	15,000	0.621	9,315
			2,14,340

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PV of minimum lease payments and unguaranteed residual value at guessed rate 14%

Year	**MLP + UGR Rs.**	**DF (10%)**	**PV Rs.**
1	50,000	0.877	43,850
2	50,000	0.769	38,450
3	50,000	0.675	33,750
4	50,000	0.592	29,600
5	50,000	0.519	25,950
5	25,000	0.519	12,975
5	15,000	0.519	7,785
			1,92,360

Interest rate implicit on lease is computed below by interpolation:

Interest rate implicit on lease = $10\% + \frac{14\% - 10\%}{2{,}14{,}340 - 1{,}92{,}360} \times (2{,}14{,}340 - 2{,}00{,}000) = 12.6\%$

Example 2

Annual lease rents	=	Rs.50,000 at the end of each year.
Lease period	=	5 years;
Guaranteed residual value	=	Rs.25,000
Unguaranteed residual value (UGR)	=	Rs.15,000
Fair Value at the inception (beginning) of lease	=	Rs.2,00,000
Interest rate implicit on lease is	=	12.6%

Present value of minimum lease payment is computed below:

Year	MLP Rs.	DF (12.6%)	PV Rs.
1	50,000	0.890	44,500
2	50,000	0.790	39,500
3	50,000	0.700	35,000
4	50,000	0.622	31,100
5	50,000	0.552	27,600
5	25,000	0.552	13,800
			1,91,500

Present value of minimum lease payment = Rs.1,91,500

Fair value of leased asset = Rs.2,00,000

The accounting entry at the inception of lease to record the asset taken on finance lease in books of lessee is suggested below:

		Rs.	Rs.
Asset A/c	Dr.	1,91,500	
To Lessor (Lease Liability) A/c			1,91,500
(Being recognition of finance lease as asset and liability)			

		Rs.	Rs.
Asset A/c	Dr.	1,91,500	
To Lessor (Lease Liability) A/c			1,91,500
(Being recognition of finance lease as asset and liability)			

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Example 3

Using data for example 2 and assuming zero residual value, allocation of finance charge over lease period is shown below:

Year	Minimum Lease Payments Rs.	Finance Charge (12.6%) Rs.	Principal Rs.	Principal due Rs.
0	--	--	--	1,91,500
1	50,000	24,129	25,871	1,65,629
2	50,000	20,869	29,131	1,36,498
3	50,000	17,199	32,801	1,03,697
4	50,000	13,066	36,934	66,763
5	75,000	8,237*	66,763	
	2,75,000	83,500	1,91,500	

Accounting entries in year 1 to recognise the finance charge in books of lessee are suggested below:

		Rs.	Rs.
Finance Charge A/c	Dr.	24,129	
To Lessor			24,129
(Being finance charge due for the year)			
Lessor	Dr.	50,000	
To Bank A/c			50,000
(Being payment of lease rent for the year)			
P & L A/c	Dr.	24,129	
To Finance Charge A/c			24,129
(Being recognition of finance charge as expense for the year)			

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Example 4

In example 2, suppose unguaranteed residual value is not determinable and lessee's incremental borrowing rate is 10%.

Since interest rate implicit on lease is discounting rate at which present value of minimum lease payment and present value of unguaranteed residual value equals the fair value, interest rate implicit on lease cannot be determined unless unguaranteed residual value is known. If interest rate implicit on lease is not determinable, the present value of minimum lease payments should be determined using lessee's incremental borrowing rate. Present value of minimum lease payment using lessee's incremental borrowing rate 10% is computed below:

Year	MLP Rs.	DF (10%)	PV Rs.
1	50,000	0.909	45,450
2	50,000	0.826	41,300
3	50,000	0.751	37,550
4	50,000	0.683	34,150
5	50,000	0.621	31,050
5	25,000	0.621	15,525
			2,05,025

Present value of minimum lease payment = Rs.2,05,025

Fair value of leased asset = Rs.2,00,000

The accounting entry at the inception of lease to record the asset taken on finance lease in books of lessee is suggested below:

	Rs.	Rs.
Asset A/c Dr.	2,00,000	
To Lessor (Lease Liability)		2,00,000
(Being recognition of finance lease as asset and liability)		

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Since the liability is recognised at fair value Rs.2 lakh (total principal), we need to ascertain a discounting rate at which present value minimum lease payments equals Rs.2 lakh. The discounting rate can then be used for allocation of finance charge over lease period.

PV of minimum lease payments at guessed rate 12%.

Year	Minimum Lease Payments Rs.	DF (12.6%)	PV Rs.
1	50,000	0.893	44,650
2	50,000	0.797	39,850
3	50,000	0.712	35,600
4	50,000	0.636	31,800
5	50,000	0.567	28,350
5	25,000	0.567	14,175
			1,94,425

Required discounting rate $= 10\% + \frac{12\% - 10\%}{2{,}05{,}025 - 1{,}94{,}425} \times (2{,}05{,}025 - 2{,}00{,}000) = 10.95\%$

Allocation of finance charge over lease period is shown below:

Year	Minimum Lease Payments Rs.	Finance Charge (12.6%) Rs.	Principal Rs.	Principal due Rs.
0	--	--	--	2,00,000
1	50,000	21,900	28,100	1,71,900
2	50,000	18,823	31,177	1,40,723
3	50,000	15,409	34,591	1,06,132
4	50,000	13,066	36,934	66,763
5	75,000	7,247*	67,753	
	2,75,000	75,000	2,00,000	

Accounting entries in year 1 to recognise the finance charge in books of lessee are suggested below:

	Rs.	Rs.
Finance Charge A/c Dr. To Lessor (Being finance charge due for the year)	21,900	21,900
Lessor Dr. To Bank A/c (Being payment of lease rent for the year)	50,000	50,000
P & L A/c Dr. To Finance Charge (Being recognition of finance charge as expense for the year)	21,900	21,900

(Refer Illustration 1)

5.8.2 Disclosures made by the Lessee

The lessee should, in addition to the requirements of AS 10 (Revised), Property, Plant and Equipment, and the governing statute, make the following disclosures for finance leases:

a. assets acquired under finance lease as segregated from the assets owned;

b. for each class of assets, the net carrying amount at the balance sheet date;

c. a reconciliation between the total of minimum lease payments at the balance sheet date and their present value. In addition, an enterprise should disclose the total of minimum lease payments at the balance sheet date, and their present value, for each of the following periods:

   i. not later than one year;

   ii. later than one year and not later than five years;

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iii. later than five years;

d. contingent rents recognised as expense in the statement of profit and loss for the period;

e. the total of future minimum sublease payments expected to be received under non-cancelable subleases at the balance sheet date; and

f. a general description of the lessee's significant leasing arrangements including, but not limited to, the following:

   i. the basis on which contingent rent payments are determined;

   ii. the existence and terms of renewal or purchase options and escalation clauses; and

   iii. restrictions imposed by lease arrangements, such as those concerning dividends, additional debt, and further leasing.

5.8.3 Accounting for finance leases (Books of lessor)

The lessor should recognise assets given under a finance lease in its balance sheet as a receivable at an amount equal to the net investment in the lease.

In a finance lease, the lessor recognises the net investment in lease (which is usually equal to fair value, i.e. usual market price of the asset, as shown below) as receivable by debiting the Lessee A/c.

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Journal entries at inception:

Particulars	Debit	Credit
Asset To Bank (Being purchase of asset by lessor at FV)	Fair value	 Fair value
Lease Receivable To Asset (Being asset by lessor given at lease)	Fair value = NI	 Fair value = NI

Where,

Gross investment in Lease (GI)

= Minimum Lease Payments (MLP) + Unguaranteed Residual value (UGRV)

Net investment in Lease (NI)

= Gross investment in Lease (GI) – Unearned Finance Income (UFI).

Unearned finance income (UFI) = GI – (PV of MLP + PV of UGRV)

The discounting rate for the above purpose is the rate of interest implicit in the lease.

From the definition of interest rate implicit on lease:

(PV of MLP + PV of UGRV) = Fair Value.

The above definitions imply that:

a. Unearned Finance Income (UFI) = GI – Fair Value

b. Net Investment in Lease = GI – UFI = GI – (GI – Fair Value) = Fair Value

Since the sale and receivables are recognised at net investment in lease, which is equal to fair value:

Profit recognised at the inception of lease = Fair Value – Cost

Total earning of lessor = GI – Cost

= (GI – Fair Value) + (Fair Value – Cost)

= Unearned Finance Income + (Fair Value – Cost)

The above analysis does not hold where the discounting rate is not equal to interest rate implicit on lease. Such is the case, where the interest rate implicit on lease is artificially low. The discounting rate in such situations should be the commercial rate of interest (refer discussion on 'manufacturer or dealer lessor' below).

5.8.4 Recognition of Finance Income

The unearned finance income is recognised over the lease term on a systematic and rational basis. This income allocation is based on a pattern reflecting a constant periodic return on the net investment in lease outstanding.

The constant periodic return is the rate used for discounting, i.e. either the interest rate implicit on lease or the commercial rate of interest.

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5.8.4 Initial Direct Costs

Initial direct costs, such as commissions and legal fees, are often incurred by lessors in negotiating and arranging a lease. For finance leases, these initial direct costs are incurred to produce finance income and are either recognised immediately in the statement of profit and loss or allocated against the finance income over the lease term.

5.8.6 Review of unguaranteed residual value by lessor

AS 19 requires a lessor to review unguaranteed residual value used in computing the gross investment in lease regularly.

In case any reduction in the estimated unguaranteed residual value is identified, the income allocation over the remaining lease term is to be revised. Also, any reduction in respect of income already accrued is to be recognised immediately.

An upward adjustment of the estimated residual value is not made.

(Refer Illustration 2)

Manufacturer or dealer lessor

The manufacturer or dealer lessor should recognise the transaction of sale in the statement of profit and loss for the period, in accordance with the policy followed by the enterprise for outright sales. If artificially low rates of interest are quoted, profit on sale should be restricted to that which would apply if a commercial rate of interest were charged. Initial direct costs should be recognised as an expense in the statement of profit and loss at the inception of the lease.

Disclosures

The lessor should make the following disclosures for finance leases:

a. a reconciliation between the total gross investment in the lease at the balance sheet date, and the present value of minimum lease payments receivable at the balance sheet date. In addition, an enterprise should disclose the total gross investment in the lease and the present value of minimum lease payments receivable at the balance sheet date, for each of the following periods:

- **i.** not later than one year;
- **ii.** later than one year and not later than five years;
- **iii.** later than five years;

b. unearned finance income;

c. the unguaranteed residual values accruing to the benefit of the lessor;

d. the accumulated provision for uncollectible minimum lease payments receivable;

e. contingent rents recognised in the statement of profit and loss for the period;

f. a general description of the significant leasing arrangements of the lessor; and

g. accounting policy adopted in respect of initial direct costs.

As an indicator of growth, it is often useful to also disclose the gross investment less unearned income in new business added during the accounting period, after deducting the relevant amounts for cancelled leases.

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5.9 ACCOUNTING FOR OPERATING LEASES

5.9.1 Accounting treatment in the Books of lessee

Lease payments under an operating lease should be recognised as an expense in the statement of profit and loss of a lessee on a straight line basis over the lease term unless another systematic basis is more representative of the time pattern of the user's benefit.

Lease payments may be tailor made to suit the payment capacity of the lessee. For example, a lease term may provide for low initial rents and high terminal rent. Such payment patterns do not reflect the pattern of benefit derived by the lessee from the use of leased asset. To have better matching between revenue and costs, AS 19 requires lessees to recognise operating lease payments as expense in the statement of profit and loss on a straight line basis over the lease term unless another systematic basis is more representative of the time pattern of the user's benefit.

Example

Suppose outputs from a machine taken on a 3 year operating lease are estimated as 10,000 units in year 1; 20,000 units in year 2 and 50,000 units in year 3. The agreed annual lease payments are Rs.25,000, Rs.45,000 and Rs.50,000 respectively.

The total lease payment Rs.1,20,000 in this example should be recognised in proportion of output as Rs.15,000 in year 1, Rs.30,000 in year 2 and Rs.75,000 in year 3. The difference between lease rent due and lease rent recognised can be debited / credited to Lease Equalisation A/c.

The accounting entries for year 1 in books of lessee are suggested below:

		Rs.	**Rs.**
Lease Rent A/c	Dr.	15,000	
Lease Equalization A/c	Dr.	10,000	
To Lessor			25,000
(Being lease rent for the year due)			
Lessor	Dr.	25,000	
To Bank A/c			25,000
(Being payment of lease rent for the year)			
P & L A/c	Dr.	15,000	
To Lease Rent A/c			15,000
(Being recognition of lease rent as expense for the year)			

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

5.9.2 Disclosures by lessees

The paragraph 25 requires lessees to make following disclosures for operating leases:

a. the total of future minimum lease payments under non-cancellable operating leases for each of the following periods:

- **i.** not later than one year;
- **ii.** later than one year and not later than five years;
- **iii.** later than five years;

b. the total of future minimum sublease payments expected to be received under non-cancellable subleases at the balance sheet date;

c. lease payments recognised in the statement of profit and loss for the period, with separate amounts for minimum lease payments and contingent rents;

d. sub-lease payments received (or receivable) recognised in the statement of profit and loss for the period;

e. a general description of the lessee's significant leasing arrangements including, but not limited to, the following:

   i. the basis on which contingent rent payments are determined;

   ii. the existence and terms of renewal or purchase options and escalation clauses; and

   iii. restrictions imposed by lease arrangements, such as those concerning dividends, additional debt, and further leasing.

5.9.3 Accounting treatment in the books of lessor

i. The lessor should present an asset given under operating lease as PPE in its balance sheets.

ii. Lease income from operating leases should be recognised in the statement of profit and loss on a straight line basis over the lease term, unless another systematic basis is more representative of the time pattern in which benefit derived from the use of the leased asset is diminished.

iii. Depreciation should be recognised in the books of lessor. The depreciation of leased assets should be on a basis consistent with the normal depreciation policy of the lessor for similar assets, and the depreciation charge should be calculated on the basis set out in AS 10.

iv. The impairment losses on assets given on operating leases are determined and treated as per AS 28

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We can summarize the accounting treatment for the lessor and lessee for an operating lease as under:

Particulars	Books of lessor	Books of Lessee
Asset	Continues to appear in his books	Asset does not appear in his books
Depreciation	Yes – charged	Not applicable
Impairment	Yes – applicable	Not applicable
Lease rent	Income recognized on SLM	Expense recognized on SLM

Initial direct costs incurred specifically to earn revenues from an operating lease are either deferred and allocated to income over the lease term in proportion to the recognition of rent income, or are recognised as an expense in the statement of profit and loss in the period in which they are incurred. A manufacturer or dealer lessor should recognise the asset given on operating lease as PPE in their books by debiting concerned PPE A/c and crediting Cost of Production / Purchase at cost. No selling profit should be recognised on entering into operating lease, because such leases are not equivalents of sales.

Suppose outputs from a machine of economic life of 6 years are estimated as 10,000 units in year 1, 20,000 units in year 2 and 30,000 units in year 3, 40,000 units in year 4, 20,000 units in year 5 and 5,000 units in year 6. The machine was given on 3-year operating lease by a dealer of the machine for equal annual lease rentals to yield 20% profit margin on cost Rs.5,00,000. Straight-line depreciation in proportion of output is considered appropriate.

Total lease rent $= 120\% \text{ of Rs.5 lakhs} \times \frac{\text{Output during lease period}}{\text{Total output}}$

$$= \text{Rs.6 lakhs} \times \frac{60{,}000 \text{ units}}{1{,}25{,}000 \text{ units}} = \text{Rs.2.88 lakhs}$$

Annual lease rent = Rs.2,88,000 / 3 = Rs.96,000

Total lease rent should be recognised as income in proportion of output during lease period, i.e. in the proportion of 10 : 20 : 30. Hence income recognised in years 1, 2 and 3 are Rs.48,000, Rs.96,000 and Rs.1,44,000 respectively.

Since depreciation in proportion of output is considered appropriate, the depreciable amount Rs.5 lakh should be allocated over useful life 6 years in proportion of output, i.e. in proportion of 10 : 20 : 30 : 40 : 20 : 5. Depreciation for year 1 is Rs.40,000.

The accounting entries for year 1 in books of lessor are suggested below:

		Rs.	**Rs.**
Machine given on Operating Lease	Dr.	5,00,000	
To Purchase			5,00,000
(Being machine given on operating lease brought into books)			
Lessee	Dr.	96,000	
To Lease Equalization A/c			48,000
To Lease Rent (Being lease rent for the year due)			48,000
Bank	Dr.	96,000	
To Lessee			96,000
(Being receipt of lease rent for the year)			
Lease Rent	Dr.	48,000	
To P & L A/c			48,000
(Being recognition of lease rent as income for the year)			
Depreciation	Dr.	40,000	
To Machine given on Operating Lease			40,000
(Being depreciation for the year)			

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P & L A/c Dr.	40,000	
To Depreciation		40,000
(Being depreciation for the year transferred to P & L A/c)		

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

5.9.4 Disclosures by lessors

As per AS 19, the lessor should, in addition to the requirements of AS 10 (Revised) and the governing statute, make the following disclosures for operating leases:

a. for each class of assets, the gross carrying amount, the accumulated depreciation and accumulated impairment losses at the balance sheet date; and

  i. the depreciation recognized in the statement of profit and loss for the period;

  ii. impairment losses recognized in the statement of profit and loss for the period;

  iii. impairment losses reversed in the statement of profit and loss for the period;

b. the future minimum lease payments under non-cancellable operating leases in the aggregate and for each of the following periods:

  i. not later than one year;

  ii. later than one year and not later than five years;

  iii. later than five years;

c. total contingent ren recognized as income in the statement of profit and loss for the period;

d. a general description of the lessor ’s significant leasing arrangements; and

e. accounting policy adopted in respect of initial direct costs.

5.10 SALE AND LEASEBACK

The basis of a sale and leaseback agreement is simply that one sells an asset for cash and then leases it back from the buyer. The asset subject to such sale and leaseback agreement is generally property. Under such an agreement the property owner agrees to sell the property at an agreed valuation and lease it back from the buyer. The lessee or seller receives cash immediately and makes periodic payment in form of lease rents for right to use the property. The lease payments and the sale price are generally interdependent as they are negotiated as a package. The accounting treatment of a sale and lease back depends upon the type of lease involved. Accounting treatment of profits / losses on sale of asset, as required by the standard in respect of sale and lease-back transactions, are summarised below.

SHRESHTA

The accounting treatment depends upon the classification of the lease in the books of the seller-lessee.

Situation I

- **Where sale and leaseback results in finance lease**

  The excess or deficiency of sales proceeds over the carrying amount should be deferred and amortised over the lease term in proportion to the depreciation of the leased asset.

  Situation II

- **Where sale and leaseback results in operating lease**

Case 1: Sale price = Fair Value

Profit or loss should be recognised immediately.

Case 2: Sale Price < Fair Value

Profit and loss should be recognised immediately. However if the loss is compensated by future lease payments at below market price, it should be deferred and amortised in proportion to the lease payments over the period for which the asset is expected to be used.

Case 3: Sale Price > Fair Value

The excess over fair value should be deferred and amortised over the period for which the asset is expected to be used.

For operating leases, if the fair value at the time of a sale and leaseback transaction is less than the carrying amount of the asset, a loss equal to the amount of the difference between the carrying amount and fair value should be recognised immediately.

For finance leases, no such adjustment is necessary unless there has been an impairment in value, in which case the carrying amount is reduced to recoverable amount in accordance with AS 28.

Thus it can be summarised as:

Sale price at fair value	Carrying amount equal to fair value	Carrying amount less than fair value	Carrying amount above fair value
Profit	No Profit	Recognise profit immediately	Not Applicable
Loss	No Loss	Not Applicable	Recognise loss immediately

Sale price at fair value	Carrying amount equal to fair value	Carrying amount less than fair value	Carrying amount above fair value
Profit	No Profit	Recognise profit immediately	No Profit. (Carrying amount of an asset to be written down to fair value)
Loss not compensated by future lease payments at below market price	Recognise loss immediately	Recognise loss immediately	Carrying amount of an asset to be written down to fair value
Loss compensated by future lease payments at below market price	Defer and amortise loss.	Defer and amortise loss.	Carrying amount of an asset to be written down to fair value

Sale price at fair value	Carrying amount equal to fair value	Carrying amount less than fair value	Carrying amount above fair value
Profit	Defer and amortise profit.	**1.** Difference between carrying amount and fair value to be immediately recognised. **2.** Excess over fair value to be Deferred and amortised.	Defer and amortise profit. (The profit would be the difference between fair value and sale price as the carrying amount would have been written down to fair value)
Loss	No Loss	No Loss	**1.** Carrying amount of an asset to be written down to fair value. **2.** Defer and amortise the difference of sale price and fair value.

(Refer Illustration 3)

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ILLUSTRATIONS

Illustration 1

S. Square Private Limited has taken machinery on finance lease from S.K. Ltd. The information is as under:

Lease term = 4 years

Fair value at inception of lease = Rs.20,00,000

Lease rent = Rs.6,25,000 p.a. at the end of year

Guaranteed residual value = Rs.1,25,000

Expected residual value = Rs.3,75,000

Implicit interest rate = 15%

Discounted rates for 1st year, 2nd year, 3rd year and 4th year are 0.8696, 0.7561, 0.6575 and 0.5718 respectively.

Calculate the value of the lease liability as per AS-19 and disclose impact of this on Balance sheet and Profit & loss account at the end of year 1

Solution

According to para 11 of AS 19 "Leases", the lessee should recognise the lease as an asset and a liability at an amount equal to the lower of the fair value of the leased asset at the inception of the finance lease and the present value of the minimum lease payments from the standpoint of the lessee.

In calculating the present value of the minimum lease payments the discount rate is the interest rate implicit in the lease. Present value of minimum lease payments will be calculated as follows:

Year	Minimum Lease Payment Rs.	Implicit interest rate (Discount rate @15%)	Present value Rs.
1	6,25,000	0.8696	5,43,500
2	6,25,000	0.7561	4,72,563
3	6,25,000	0.6575	4,10,937
4	7,50,000*	0.5718	4,28,850
Total	26,25,000		18,55,850

Present value of minimum lease payments Rs.18,55,850 is less than fair value at the inception of lease i.e. Rs.20,00,000, therefore, the asset and corresponding lease liability should be recognised at Rs.18,55,850 as per AS 19.

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Illustration 2

Prakash Limited leased a machine to Badal Limited on the following terms:

		(Rs. In lakhs)
i.	Fair value of the machine	28.3
ii.	Lease term	5 years
iii.	Lease rental per annum	8.00
iv.	Guaranteed residual value	1.60
v.	Expected residual value	3.00
vi.	Internal rate of return	15%

Discounted rates for 1st year to 5th year are 0.8696, 0.7561, 0.6575, 0.5718, and 0.4972 respectively. Ascertain Unearned Finance Income.

Solution

As per AS 19 on Leases, **unearned finance income** is the difference between (a) the **gross investment** in the lease and (b) the present value of minimum lease payments under a finance lease from the standpoint of the lessor; and any unguaranteed residual value accruing to the lessor, at the interest rate implicit in the lease.

Where:

a. **Gross investment** in the lease is the aggregate of (i) minimum lease payments from the stand point of the lessor and (ii) any unguaranteed residual value accruing to the lessor.

Gross investment

= Minimum lease payments + Unguaranteed residual value

= [Total lease rent + Guaranteed residual value (GRV)] + Unguaranteed residual value (URV)

= [(Rs.8,00,000 $\times$ 5 years) + Rs.1,60,000] + Rs.1,40,000

= Rs.43,00,000 (a)

b. Table showing present value of (i) Minimum lease payments (MLP) and (ii) Unguaranteed residual value (URV).

Year	MLP inclusive of URV Rs.	Implicit interest rate (Discount rate @15%)	Present value Rs.
1	8,00,000	0.8696	6,95,680
2	8,00,000	0.7561	6,04,880
3	8,00,000	0.6575	5,26,000
4	8,00,000	0.5718	4,57,440

5	8,00,000	0.4972	3,97,760
	1,60,000 (GRV)	0.4972	79,552
	41,60,000		27,61,312 (i)
	1,40,000 (URV)	0.4972	69,608 (ii)
	43,00,000	(i)+ (ii)	28,30,920 (b)

Unearned Finance Income (a) - (b) = Rs.43,00,000 – Rs.28,30,920= Rs.14,69,080.

Illustration 3

A Ltd. sold machinery having WDV of Rs.40 lakhs to B Ltd. for Rs.50 lakhs and the same machinery was leased back by B Ltd. to A Ltd. The lease back is operating lease. Comment if –

a. **Sale price of Rs.50 lakhs is equal to fair value.**
b. **Fair value is Rs.60 lakhs.**
c. **Fair value is Rs.45 lakhs and sale price is Rs.38 lakhs.**
d. **Fair value is Rs.40 lakhs and sale price is Rs.50 lakhs.**
e. **Fair value is Rs.46 lakhs and sale price is Rs.50 lakhs**
f. **Fair value is Rs.35 lakhs and sale price is Rs.39 lakhs.**

Solution

Following will be the treatment in the given cases:

a. When sales price of Rs.50 lakhs is equal to fair value, A Ltd. should immediately recognise the profit of Rs.10 lakhs (i.e. 50 – 40) in its books.

b. When fair value is Rs.60 lakhs then also profit of Rs.10 lakhs should be immediately recognised by A Ltd.

c. When fair value of leased machinery is Rs.45 lakhs & sales price is Rs.38 lakhs, then loss of Rs.2 lakhs (40 – 38) to be immediately recognised by A Ltd. in its books provided loss is not compensated by future lease payment, otherwise defer and amortise the loss.

d. When fair value is Rs.40 lakhs & sales price is Rs.50 lakhs then, profit of Rs.10 lakhs is to be deferred and amortised over the lease period.

e. When fair value is Rs.46 lakhs & sales price is Rs.50 lakhs, profit of Rs.6 lakhs (46 - 40) to be immediately recognised in its books and balance profit of Rs.4 lakhs (50-46) is to be amortised / deferred over lease period.

f. When fair value is Rs.35 lakhs & sales price is Rs.39 lakhs, then the loss of Rs.5 lakhs (40-35) to be immediately recognised by A Ltd. in its books and profit of Rs.4 lakhs (39-35) should be amortised / deferred over lease period.

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TEST YOUR KNOWLEDGE

MCQs

1. **A Ltd. sold machinery having WDV of Rs.40 lakhs to B Ltd. for Rs.50 lakhs (Fair value Rs.50 lakhs) and same machinery was leased back by B Ltd. to A Ltd. The lease back is in nature of operating lease. The treatment will be**
   a. **A Ltd. should amortise the profit of Rs.10 lakhs over lease term.**
   b. **A Ltd. should recognise the profit of Rs.10 lakhs immediately.**
   c. **A Ltd. should defer the profit of Rs.10 lakhs.**
   d. **B Ltd. should recognise the profit of Rs.10 lakhs immediately.**

2. **In case of an operating lease – identify which statement is correct:**
   a. **The lessor continues to show the leased asset in its books of accounts.**
   b. **The lessor de-recognises the asset from its Balance Sheet.**
   c. **The lessor discontinues to claim depreciation in its books.**
   d. **The lessee recognises the asset in its Balance Sheet.**

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3. **In case of finance lease, if the asset is returned back to the lessor at the end of the lease term - the lessee always claims depreciation based on which of the following:**
   a. **Useful life.**
   b. **Lease term.**
   c. **Useful life or lease term whichever is less.**
   d. **Useful life or lease term whichever is higher.**

4. **AS 19 lays down 5 deterministic conditions to classify the lease as a finance lease. To classify the lease as an operating lease – which statement is correct?**
   a. **Any 1 condition fails.**
   b. **Majority of the 5 conditions fail.**
   c. **All 5 conditions fail.**
   d. **Any 2 conditions fails.**

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

ANSWERS/SOLUTIONS

MCQs

1.	**b.**	A Ltd. should recognise the profit of Rs.10 lakhs immediately.
2.	**a.**	The lessor continues to show the leased asset in its books of accounts.
3.	**c.**	Useful life or lease term whichever is less.
4.	**c.**	All 5 conditions fail.
5.	**b.**	Risk and reward Test.

THEORETICAL QUESTIONS

Q.NO.1. Explain the types of lease as per AS 19.

ANSWER

For the purpose of accounting AS 19, classifies leases into two categories as follows:

1. Finance Lease
2. Operating Lease

Finance Lease:

It is a lease, which transfers substantially all the risks and rewards incidental to ownership of an asset to the lessee by the lessor but not the legal ownership.

As per para 8 of the standard, in following situations, the lease transactions are called Finance lease:

1. The lessee will get the ownership of leased asset at the end of the lease term.
2. The lessee has an option to buy the leased asset at the end of the lease term at price, which is lower than its expected fair value at the date on which option will be exercised.
3. The lease term covers the major part of the life of asset even if title is not transferred.
4. At the beginning of lease term, present value of minimum lease rental covers the initial fair value.
5. The asset given on lease to lessee is of specialized nature and can only be used by the lessee without major modification.

Operating Lease:

It is lease, which does not transfer all the risks and rewards incidental to ownership.

Q.NO.2. Explain the accounting treatment for a sale and leaseback transaction under Operating lease.

ANSWER

As per AS 19, where sale and leaseback results in operating lease, then the accounting treatment in different situations is as follows:

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Situation 1: Sale price = Fair Value

Profit or loss should be recognized immediately.

Situation 2: Sale Price < Fair Value

Profit should be recognized immediately. The loss should also be recognized immediately except that, if the loss is compensated by future lease payments at below market price, it should be deferred and amortized in proportion to the lease payments over the period for which the asset is expected to be used.

Situation 3: Sale Price > Fair Value

The excess over fair value should be deferred and amortized over the period for which the asset is expected to be used.

Q.NO.3. What do you understand by the term "Interest rate implicit on lease"?

ANSWER

As per para 3 of AS 19 'Leases' the interest rate implicit in the lease is the discount rate that, at the inception of the lease, causes the aggregate present value of:

a. the minimum lease payments under a finance lease from the standpoint of the lessor; and

b. any unguaranteed residual value accruing to the lessor, to be equal to the fair value of the leased asset.

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Q.NO.4. What are the disclosures requirements for operating leases by the lessee as per AS-19?

ANSWER

As per AS 19, lessees are required to make following disclosures for operating leases:

a. the total of future minimum lease payments under non-cancellable operating leases for each of the following periods:
   - **i.** not later than one year;
   - **ii.** later than one year and not later than five years;
   - **iii.** later than five years;

b. the total of future minimum sublease payments expected to be received under non- cancellable subleases at the balance sheet date;

c. lease payments recognized in the statement of profit and loss for the period, with separate amounts for minimum lease payments and contingent rents;

d. sub-lease payments received (or receivable) recognized in the statement of profit and loss for the period;

e. a general description of the lessee's significant leasing arrangements including, but not limited to, the following:
   i. the basis on which contingent rent payments are determined;
   ii. the existence and terms of renewal or purchase options and escalation clauses; and
   iii. restrictions imposed by lease arrangements, such as those concerning dividends, additional debt, and further leasing.

PRACTICAL QUESTIONS

Q.NO.1. Classify the following into either operating or finance lease:

i. Lessee has option to purchase the asset at lower than fair value, at the end of lease term;

ii. Economic life of the asset is 7 years, lease term is 6 years, but asset is not acquired at the end of the lease term;

iii. Economic life of the asset is 6 years, lease term is 2 years, but the asset is of special nature and has been procured only for use of the lessee;

iv. Present value (PV) of Minimum lease payment (MLP) = "X". Fair value of the asset is "Y".

SOLUTION

i. If it becomes certain at the inception of lease itself that the option will be exercised by the lessee, it is a Finance Lease.

ii. The lease will be classified as a finance lease, since a substantial portion of the life of the asset is covered by the lease term.

iii. Since the asset is procured only for the use of lessee, it is a finance lease.

iv. The lease is a finance lease if X = Y, or where X substantially equals Y.

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Q.NO.2. A machine was given on 3 years operating lease by a dealer of the machine for equal annual lease rentals to yield 30% profit margin on cost Rs.1,50,000. Economic life of the machine is 5 years and output from the machine are estimated as 40,000 units, 50,000 units, 60,000 units, 80,000 units and 70,000 units consecutively for 5 years. Straight line depreciation in proportion of output is considered appropriate. Compute the following:

i. Annual Lease Rent

ii. Lease Rent income to be recognized in each operating year and

iii. Depreciation for 3 years of lease.

SOLUTION

i. Annual lease rent

Total lease rent

$= 130\% \text{ of Rs.}1{,}50{,}000 \times \frac{\text{Output during lease period}}{\text{Total output}}$

=130% of Rs.1,50,000 x (40,000 +50,000+ 60,000)/(40,000 + 50,000 + 60,000 + 80,000 + 70,000)

= 1,95,000 x 1,50,000 units/3,00,000 units = Rs.97,500

Annual lease rent = Rs.97,500 / 3 = Rs.32,500

ii. **Lease rent Income to be recognized in each operating year**

Total lease rent should be recognised as income in proportion of output during lease period, i.e. in the proportion of 40 : 50 : 60.

Hence income recognised in years 1, 2 and 3 will be as:

Year 1 Rs.26,000,

Year 2 Rs.32,500 and

Year 3 Rs.39,000.

iii. **Depreciation for three years of lease**

Since depreciation in proportion of output is considered appropriate, the depreciable amount Rs.1,50,000 should be allocated over useful life 5 years in proportion of output, i.e. in proportion of 40 : 50 : 60 : 80 : 70 .

Depreciation for year 1 is Rs.20,000, year 2 = 25,000 and year 3 = 30,000.

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Q.NO.3. Lessee Ltd. took a machine on lease from Lessor Ltd., the fair value being Rs.7,00,000. The economic life of machine as well as the lease term is 3 years. At the end of each year Lessee Ltd. pays Rs.3,00,000. The Lessee has guaranteed a residual value of Rs.22,000 on expiry of the lease to the Lessor. However, Lessor Ltd., estimates that the residual value of the machinery will be only Rs.15,000. The implicit rate of return is 15% p.a. and present value factors at 15% are 0.869, 0.756 and 0.657 at the end of first, second and third years respectively.

Calculate the value of machinery to be considered by Lessee Ltd. and the finance charges in each year.

SOLUTION

As per para 11 of AS 19 "Leases", the lessee should recognize the lease as an asset and a liability at the inception of a finance lease. Such recognition should be at an amount equal to the fair value of the leased asset at the inception of lease. However, if the fair value of the leased asset exceeds the present value of minimum lease payment from the standpoint of the lessee, the amount recorded as an asset and liability should be the present value of minimum lease payments from the standpoint of the lessee.

Computation of Value of machinery:

Present value of minimum lease payment = Rs.6,99,054

(See working note below)

Fair value of leased asset = Rs.7,00,000

Therefore, the recognition will be at the lower of the two i.e. 6,99,054

Working Note - Present value of minimum lease payments:

Annual lease rental × PVIF+ Present value of guaranteed residual value

= Rs.3,00,000 × (0.869 + 0.756 + 0.657) + Rs.22,000 × 0.657

= Rs.6,84,600 + Rs.14,454 = 6,99,054

Computation of finance charges:

Year	Finance charge	Payment	Reduction in outstanding liability	Outstanding liability
1st Year beginning	–	–	–	6,99,054
End of 1st year	1,04,858	3,00,000	1,95,142	5,03,912
End of 2nd year	75,587	3,00,000	2,24,413	2,79,499
End of 3rd year	41,925	3,00,000	2,58,075	21,424

Q.NO.4. B&P Ltd. availed a lease from N&L Ltd. The conditions of the lease terms are as under:

i. Lease period is 3 years, in the beginning of the year 2009, for equipment costing Rs.10,00,000 and has an expected useful life of 5 years.

ii. The Fair market value is also Rs.10,00,000

iii. The property reverts back to the lessor on termination of the lease.

iv. The unguaranteed residual value is estimated at Rs.1,00,000 at the end of the year 2011.

v. 3 equal annual payments are made at the end of each year.

vi. Consider IRR = 10%.

The present value off Rs.1 due at the end of 3rd year at 10% rate of interest is Rs.0.7513. The present value of annuity of Rs.1 due at the end of 3rd year at 10% IRR is Rs.2.4868.

State whether the lease constitute finance lease and also calculate unearned finance income.

SOLUTION

Computation of annual lease payment:

Particulars	Rs.
Cost of equipment	10,00,000
Unguaranteed residual value	1,00,000
Present value of unguaranteed residual value (Rs. 1,00,000 x 0.7513)	75,130
Present value of lease payments	

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(Rs. 10,00,000 - Rs. 75,130)	9,24,870
Present value of annuity for three years is 2.4868	
Annual lease payment [9,24,870/2.4868]	3,71,911.70

Classification of lease:

Parameter 1:

The present value of lease payment i.e., Rs. 9,24,870 which equals 92.48% of the fair market value i.e., Rs. 10,00,000.

The present value of minimum lease payments substantially covers the fair value of the leased asset

Parameter 2:

The lease term (i.e. 3 years) covers the major part of the life of asset (i.e. 5 years).

Therefore, it constitutes a finance lease.

Computation of Unearned Finance Income:

Particulars	Rs.
Total lease payments (Rs. 3,71,911.70 x 3)	11,15,735
Add: Unguaranteed residual value	1,00,000
Gross investment in the lease	1,215,735
Less: Present value of lease payments and residual value i.e.	
Net Investment (Rs. 75,130 + Rs. 9,24,870)	(10,00,000)
Unearned finance income	**2,15,735**

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Q.NO.5. X Ltd. sold machinery having WDV of Rs. 300 lakhs to Y Ltd. for Rs. 400 lakhs and the same machinery was leased back by Y Ltd. to X Ltd. The lease back arrangement is operating lease. Give your comments in the following situations:

i. Sale price of Rs. 400 lakhs is equal to fair value.

ii. Fair value is Rs. 450 lakhs.

iii. Fair value is Rs. 350 lakhs and the sale price is Rs. 250 lakhs.

iv. Fair value is Rs. 300 lakhs and sale price is Rs. 400 lakhs.

v. Fair value is Rs. 250 lakhs and sale price is Rs. 290 lakhs.

SOLUTION

Accounting Treatment:

S. No.	Particulars	Accounting Treatment
i.	When sale price of Rs. 400 lakhs is equal to fair value	X Ltd. should immediately recognize the profit of Rs. 100 lakhs (i.e. 400 – 300) in its books.

ii.	When fair value is Rs. 450 lakhs	Profit of Rs.100 lakhs should be immediately recognized by X Ltd.
iii.	When fair value of leased machinery is Rs. 350 lakhs & sales price is Rs. 250 lakhs	Then loss of Rs. 50 lakhs (300 – 250) to be immediately recognized by X Ltd. in its books provided loss is not compensated by future lease payment.
iv.	When fair value is Rs. 300 lakhs & sales price is Rs. 400 lakhs	Then, profit of Rs. 100 lakhs is to be deferred and amortized over the lease period.
v.	When fair value is Rs. 250 lakhs & sales price is Rs. 290 lakhs	Then the loss of Rs. 50 lakhs (300-250) to be immediately recognized by X Ltd. in its books and profit of Rs. 40 lakhs (290-250) should be amortized/ deferred over lease period.

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UNIT 6: ACCOUNTING STANDARD 26: INTANGIBLE ASSETS

LEARNING OUTCOMES

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

- Definition of Intangible Assets
- Parameters for Recognition and Initial Measurement of an Intangible Asset
  - Separate Acquisition
  - Acquisition as part of an Amalgamation
  - Acquisition by way of a Government Grant
  - Exchanges of Assets
  - Internally Generated Goodwill and other Intangible Assets
- Measurement Subsequent to Initial Recognition
- Principles for
  - Amortisation Period
  - Amortisation Method
  - Residual Value
  - Review of Amortisation Period and Amortisation Method
- Retirements and Disposals
- Disclosures as per the standard.

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6.1 INTRODUCTION

The objective of AS 26 is to prescribe the accounting treatment for intangible assets that are not dealt with specifically in another Accounting Standard. AS 26 requires an enterprise to recognise an intangible asset if, and only if, certain criteria are met. AS 26 also specifies how to measure the carrying amount of intangible assets and requires certain disclosures about intangible assets.

6.2 SCOPE AS 26 should be applied by all enterprises in accounting for intangible assets, except:

i. Intangible assets that are covered by another Accounting Standard, such as:

a. Intangible assets held by an enterprise for sale in the ordinary course of business (AS 2, Valuation of Inventories and AS 7, Construction Contracts)

b. Deferred tax assets (AS 22, Accounting for Taxes on Income)

c. Leases that fall within the scope of AS 19, Leases; and

d. Goodwill arising on an amalgamation (AS 14 (Revised), Accounting for Amalgamations) and goodwill arising on consolidation (AS 21 (Revised), Consolidated Financial Statements)

ii. Financial assets.

iii. Mineral rights and expenditure on the exploration for, or development and extraction of, minerals, oil, natural gas and similar non-regenerative resources and

iv. Intangible assets arising in insurance enterprises from contracts with policyholders.

v. expenditure in respect of termination benefits.

However, AS 26 applies to other intangible assets used (such as computer software), and other expenditure (such as start-up costs), in extractive industries or by insurance enterprises.

AS 26 also applies to:

i. Expenditure on advertising, training, start - up cost

ii. Research and development activities

iii. Right under licensing agreements for items such as motion picture films, video recordings, plays, manuscripts, patents and copyrights. These items are excluded from the scope of AS 19.

iv. The underlying intangible asset in finance lease after its initial recognition.

6.3 DEFINITIONS

An asset is a resource:

a. Controlled by an enterprise as a result of past events and

b. From which future economic benefits are expected to flow to the enterprise.

Monetary assets are money held and assets to be received in fixed or determinable amounts of money.

Non-monetary assets are assets other than monetary assets.

Amortisation is the systematic allocation of the depreciable amount of an intangible asset over its useful life.

Depreciable amount is the cost of an asset less its residual value.

Useful life is either:

a. the period of time over which an asset is expected to be used by the enterprise; or

b. the number of production or similar units expected to be obtained from the asset by the enterprise.

Fair value of an asset is the amount for which that asset could be exchanged between knowledgeable, willing parties in an arm's length transaction.

An active market is a market where all the following conditions exist:

a. The items traded within the market are homogeneous.

b. Willing buyers and sellers can normally be found at any time and

c. Prices are available to the public.

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An impairment loss is the amount by which the carrying amount of an asset exceeds its recoverable amount.

Carrying amount is the amount at which an asset is recognised in the balance sheet, net of any accumulated amortisation and accumulated impairment losses thereon.

A financial asset is any asset that is:

a. Cash.

b. A contractual right to receive cash or another financial asset from another enterprise.

c. A contractual right to exchange financial instruments with another enterprise under conditions that are potentially favourable. or

d. An ownership interest in another enterprise.

Termination benefits are employee benefits payable as a result of either:

a. an enterprise's decision to terminate an employee's employment before the normal retirement date. or

b. an employee's decision to accept voluntary redundancy in exchange for those benefits (voluntary retirement).

Intangible Asset is

- an identifiable
- non-monetary asset
- without physical substance
- held for use in the production or supply of goods or services, for rental to others, or for administrative purposes.

Enterprises frequently expend resources, or incur liabilities, on the acquisition, development, maintenance or enhancement of intangible resources such as scientific or technical knowledge, design and implementation of new processes or systems, licences, intellectual property, market knowledge and trademarks (including brand names and publishing titles). Common examples are computer software, patents, copyrights, motion picture films, customer lists, mortgage servicing rights, fishing licences, import quotas, franchises, customer or supplier relationships, customer loyalty, market share and marketing rights. Goodwill is another example of an item of intangible nature which either arises on acquisition or is internally generated.

Not all the items described above will meet the definition of an intangible asset, that is, identifiability, control over a resource and expectation of future economic benefits flowing to the enterprise. If an item covered by AS 26 does not meet the definition of an intangible asset, expenditure to acquire it or generate it internally is recognised as an expense when it is incurred.

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Some intangible assets may be contained in or on a physical substance such as a compact disk (in the case of computer software), legal documentation (in the case of a licence or patent) or film (in the case of motion pictures). The cost of the physical substance containing the intangible assets is usually not significant. Accordingly, the physical substance containing an intangible asset, though tangible in nature, is commonly treated as a part of the intangible asset contained in or on it.

In some cases, an asset may incorporate both intangible and tangible elements that are, in practice, inseparable. Judgement is required to assess as to which element is predominant. For example, computer software for a computer controlled machine tool that cannot operate without that specific software is an integral part of the related hardware and it is treated as a fixed asset. The same applies to the operating system of a computer. Where the software is not an integral part of the related hardware, computer software is treated as an intangible asset.

6.4 IDENTIFIABILITY

- The definition of an intangible asset requires that an intangible asset be identifiable. To be identifiable, it is necessary that the intangible asset is clearly distinguished from goodwill.
- An intangible asset can be clearly distinguished from goodwill if the asset is separable which means that enterprise could rent, sell, exchange or distribute the specific future economic benefits attributable to the asset without also disposing of future economic benefits that flow from other assets used in the same revenue earning activity.
- Separability is not a necessary condition for identifiability since an enterprise may be able to identify an asset in some other way. For example, if an intangible asset is acquired with a group of assets, the transaction may involve the transfer of legal rights that enable an enterprise to identify the intangible asset. Also, even If an asset generates future economic benefits only in combination with other assets, the asset is identifiable if the enterprise can identify the future economic benefits that will flow from the asset.

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6.5 CONTROL

An enterprise controls an asset if the enterprise has the power to obtain the future economic benefits flowing from the underlying resource and also can restrict the access of others to those benefits. The capacity of an enterprise to control the future economic benefits from an intangible asset would normally stem from legal rights that are enforceable in a court of law. However, legal enforceability of a right is not a necessary condition for control since an enterprise may be able to control the future economic benefits in some other way.

Market and technical knowledge may give rise to future economic benefits. An enterprise controls those benefits if, for example, the knowledge is protected by legal rights such as copyrights, a restraint of trade agreement or by a legal duty on employees to maintain confidentiality.

Future economic benefit is also flown from the skill of labour and customer loyalty but usually this flow of benefits cannot be controlled by the enterprise as employees may leave the enterprise anytime or even loyal customers may decide to purchase goods and services from other suppliers. Hence, these items don't even qualify as intangible asset as per the definition given in AS 26.

Example 1:

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

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

6.6 FUTURE ECONOMIC BENEFITS

The future economic benefits flowing from an intangible asset may include revenue from the sale of products or services, cost savings, or other benefits resulting from the use of the asset by the enterprise. For example, the use of intellectual property in a production process may reduce future production costs rather than increase future revenues.

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6.7 RECOGNITION AND INITIAL MEASUREMENT OF AN INTANGIBLE ASSET

The recognition of an item as an intangible asset requires an enterprise to demonstrate that the item meets the definition of an intangible asset and recognition criteria set out as below:

An intangible asset should be recognised if, and only if:

a. It is probable that the future economic benefits that are attributable to the asset will flow to the enterprise; and

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

An enterprise should assess the probability of future economic benefits using reasonable and supportable assumptions that represent best estimate of the set of economic conditions that will exist over the useful life of the asset.

An intangible asset should be measured initially at cost.

6.8 SEPARATE ACQUISITION

If an intangible asset is acquired separately, the cost of the intangible asset can usually be measured reliably. This is particularly so when the purchase consideration is in the form of cash or other monetary assets.

The cost of an intangible asset comprises:

- its purchase price,
- any import duties and other taxes (other than those subsequently recoverable by the enterprise from the taxing authorities), and
- any directly attributable expenditure on making the asset ready for its intended use. Directly attributable expenditure includes, for example, professional fees for legal services.
- Any trade discounts and rebates are deducted in arriving at the cost.

If an intangible asset is acquired in exchange for shares or other securities of the reporting enterprise, the asset is recorded at its fair value, or the fair value of the securities issued, whichever is more clearly evident.

6.9 ACQUISITION AS PART OF AN AMALGAMATION

An intangible asset acquired in an amalgamation in the nature of purchase is accounted for in accordance with AS 14 (Revised). In accordance with AS 26:

a. A transferee recognises an intangible asset that meets the recognition criteria, even if that intangible asset had not been recognised in the financial statements of the transferor and

b. If the cost (i.e. fair value) of an intangible asset acquired as part of an amalgamation in the nature of purchase cannot be measured reliably, that asset is not recognised as a separate intangible asset but is included in goodwill.

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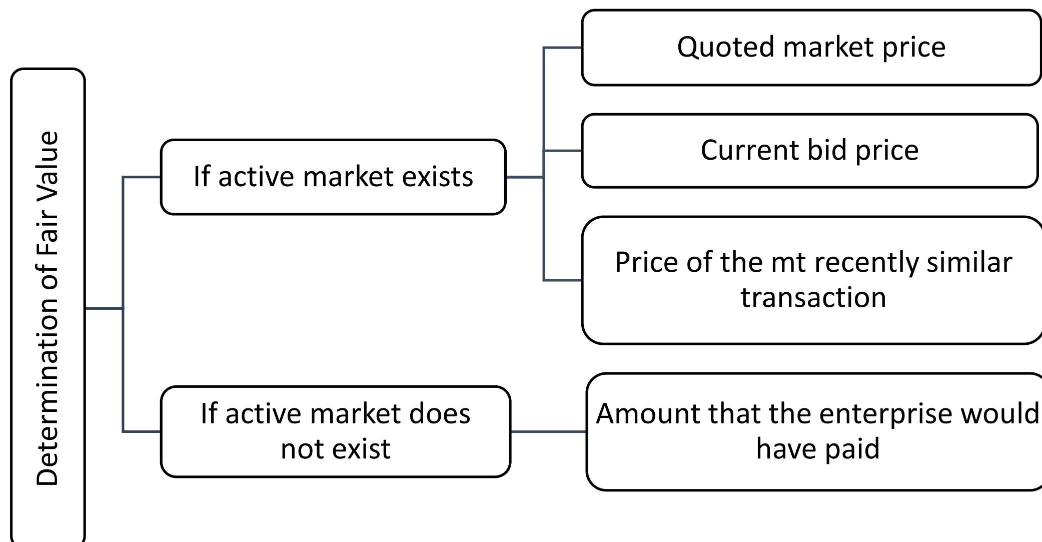
Where in preparing the financial statements of the transferee company, the consideration is allocated to individual identifiable assets and liabilities on the basis of their fair values at the date of amalgamation.

Hence, judgement is required to determine whether the cost (i.e. fair value) of an intangible asset acquired in an amalgamation can be measured with sufficient reliability for the purpose of separate recognition. Quoted market prices in an active market provide the most reliable measurement of fair value. The appropriate market price is usually the current bid price. If current bid prices are unavailable, the price of the most recent similar transaction may provide a basis from which to estimate fair value, provided that there has not been a significant change in economic circumstances between the transaction date and the date at which the asset's fair value is estimated.

If no active market exists for an asset, its cost reflects the amount that the enterprise would have paid, at the date of the acquisition, for the asset in an arm's length transaction between knowledgeable and willing parties, based on the best information available. The cost initially recognised for the intangible asset in this case is restricted to an amount that does not create or increase any capital reserve arising at the date of the amalgamation.



6.10 ACQUISITION BY WAY OF A GOVERNMENT GRANT

In some cases, an intangible asset may be acquired free of charge, or for nominal consideration, by way of a government grant. This may occur when a government transfers or allocates to an enterprise intangible assets such as airport landing rights, licences to operate radio or television stations, import licences or quotas or rights to access other restricted resources.

AS 12, requires that government grants in the form of non-monetary assets, given at a concessional rate should be accounted for on the basis of their acquisition cost.

Accordingly, intangible asset acquired free of charge, or for nominal consideration, by way of government grant is recognised at a nominal value or at the acquisition cost, as appropriate; any expenditure that is directly attributable to making the asset ready for its intended use is also included in the cost of the asset.

6.11 EXCHANGE OF ASSETS

An intangible asset may be acquired in exchange or part exchange for another asset. In such a case, the cost of the asset acquired is determined in accordance with the principles laid down in this regard in AS 10.

The cost of such an item is measured at fair value unless:

a. the exchange transaction lacks commercial substance or

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

The acquired item is measured in this manner even if an enterprise cannot immediately derecognize the asset given up. If the acquired item is not measured at fair value, its/their cost is measured at the carrying amount of the asset(s) given up.

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6.12 INTERNALLY GENERATED GOODWILL

Internally generated goodwill is not recognised as an asset because it is not an identifiable resource controlled by the enterprise that can be measured reliably at cost.

Differences between the market value of an enterprise and the carrying amount of its identifiable net assets at any point in time may be due to a range of factors that affect the value of the enterprise. However, such differences cannot be considered to represent the cost of intangible assets controlled by the enterprise.

6.13 INTERNALLY GENERATED INTANGIBLE ASSETS

It is sometimes difficult to assess whether an internally generated intangible asset qualifies for recognition. It is often difficult to:

a. identify whether, and the point of time when, there is an identifiable asset that will generate probable future economic benefits; and

b. determine the cost of the asset reliably. In some cases, the cost of generating an intangible asset internally cannot be distinguished from the cost of maintaining or enhancing the enterprise's internally generated goodwill or of running day-to- day operations.

To assess whether an internally generated intangible asset meets the criteria for recognition, an enterprise classifies the generation of the asset into

- Research Phase &
- Development Phase

If an enterprise cannot distinguish the research phase from the development phase of an internal project to create an intangible asset, the enterprise treats the expenditure on that project as if it were incurred in the research phase only.

6.14 RESEARCH PHASE

Research is original and planned investigation undertaken with the prospect of gaining new scientific or technical knowledge and understanding.

No intangible asset arising from research or from the research phase should be recognised.

Expenditure on research or on the research phase should be recognised as an expense when it is incurred.

Examples of research activities are:

a. Activities aimed at obtaining new knowledge.

b. The search for, evaluation and final selection of, applications of research findings or other knowledge.

c. The search for alternatives for materials, devices, products, processes, systems or services;

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d. The formulation, design, evaluation and final selection of possible alternatives for new or improved materials, devices, products, processes, systems or services.

6.15 DEVELOPMENT PHASE

Development is the application of research findings or other knowledge to a plan or design for the production of new or substantially improved materials, devices, products, processes, systems or services prior to the commencement of commercial production or use.

An intangible asset arising from development (or from the development phase of an internal project) should be recognised if, and only if, an enterprise can demonstrate **all** of the following:

a. The technical feasibility of completing the intangible asset so that it will be available for use or sale.

b. Its intention to complete the intangible asset and use or sell it.

c. Its ability to use or sell the intangible asset.

d. How the intangible asset will generate probable future economic benefits. Among other things, the enterprise should demonstrate the existence of a market for the output of the intangible asset or the intangible asset itself or, if it is to be used internally, the usefulness of the intangible asset.

e. The availability of adequate technical, financial and other resources to complete the development and to use or sell the intangible asset and

f. Its ability to measure the expenditure attributable to the intangible asset during its development reliably.

Examples of development activities are:

a. The design, construction and testing of pre-production or pre-use prototypes and models.

b. The design of tools, jigs, moulds and dies involving new technology.

c. The design, construction and operation of a pilot plant that is not of a scale economically feasible for commercial production and

d. The design, construction and testing of a chosen alternative for new or improved materials, devices, products, processes, systems or services.

AS 26 takes the view that expenditure on internally generated brands, mastheads, publishing titles, customer lists and items similar in substance cannot be distinguished from the cost of developing the business as a whole. Therefore, such items are not recognised as intangible assets.

To demonstrate how an intangible asset will generate probable future economic benefits, an enterprise assesses the future economic benefits to be received from the asset using the principles in Accounting Standard on Impairment of Assets. If the asset will generate economic benefits only in combination with other assets, the enterprise applies the concept of cash generating units as set out in Accounting Standard on Impairment of Assets.

SHRESHTA

6.16 COST OF AN INTERNALLY GENERATED INTANGIBLE ASSET

The cost of an internally generated intangible asset is the sum of expenditure incurred from the time when the intangible asset first meets the recognition criteria. Reinstatement of expenditure recognised as an expense in previous annual financial statements or interim financial reports is prohibited.

The cost of an internally generated intangible asset comprises all expenditure that can be directly attributed, or allocated on a reasonable and consistent basis, to creating, producing and making the asset ready for its intended use from the time when the intangible asset first meets the recognition criteria. The cost includes, if applicable:

a. Expenditure on materials and services used or consumed in generating the intangible asset.

b. The salaries, wages and other employment related costs of personnel directly engaged in generating the asset.

c. Any expenditure that is directly attributable to generating the asset, such as fees to register a legal right and the amortisation of patents and licenses that are used to generate the asset (E.g., borrowing cost as per para 4(e) of AS 16, etc.) and

d. Overheads that are necessary to generate the asset and that can be allocated on a reasonable and consistent basis to the asset. Allocations of overheads are made on bases similar to those discussed in AS 2 & AS 16.

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The following are not components of the cost of an internally generated intangible asset, these should be expensed off in profit and loss account:

a. Selling, administrative and other general overhead expenditure unless this expenditure can be directly attributed to making the asset ready for use.

b. Clearly identified inefficiencies and initial operating losses incurred before an asset achieves planned performance and

c. Expenditure on training the staff to operate the asset

Example

An enterprise is developing a new production process. During the year 20X1, expenditure incurred was Rs.10 lacs, of which Rs.9 lacs was incurred before 1 December 20X1 and 1 lac was incurred between 1 December 20X1 and 31 December 20X1. The enterprise is able to demonstrate that, at 1 December 20X1, the production process met the criteria for recognition as an intangible asset. The recoverable amount of the know-how embodied in the process (including future cash outflows to complete the process before it is available for use) is estimated to be Rs.5 lacs.

At the end of 20X1, the production process is recognised as an intangible asset at a cost of Rs.1 lac (expenditure incurred since the date when the recognition criteria were met, that is, 1 December 20X1). The Rs.9 lacs expenditure incurred before 1 December 20X1 is recognised as an expense because the recognition criteria were not met until 1 December 20X1. This expenditure will never form part of the cost of the production process recognised in the balance sheet.

During the year 20X2, expenditure incurred is Rs.20 lacs. At the end of 20X2, the recoverable amount of the know-how embodied in the process (including future cash outflows to complete the process before it is available for use) is estimated to be Rs.19 lacs.

At the end of the year 20X2, the cost of the production process is Rs.21 lacs (Rs.1 lac expenditure recognised at the end of 20X1 plus Rs.20 lacs expenditure recognised in 20X2). The enterprise recognises an impairment loss of Rs.2 lacs to adjust the carrying amount of the process before impairment loss (Rs.21 lacs) to its recoverable amount (Rs.19 lacs). This impairment loss will be reversed in a subsequent period if the requirements for the reversal of an impairment loss in AS 28, are met.

6.17 RECOGNITION OF AN EXPENSE

Expenditure on an intangible item should be recognised as an expense when it is incurred unless:

a. It forms part of the cost of an intangible asset that meets the recognition criteria or

b. The item is acquired in an amalgamation in the nature of purchase and cannot be recognised as an intangible asset. It forms part of the amount attributed to goodwill (capital reserve) at the date of acquisition.

SHRESHTA

In some cases, expenditure is incurred to provide future economic benefits to an enterprise, but no intangible asset or other asset is acquired or created that can be recognised. In these cases, the expenditure is recognised as an expense when it is incurred. For example, expenditure on research is always recognised as an expense when it is incurred.

Examples of other expenditure that is recognised as an expense when it is incurred include:

a. expenditure on start-up activities (start-up costs), unless this expenditure is included in the cost of an item of fixed asset under AS 10. Start-up costs may consist of preliminary expenses incurred in establishing a legal entity such as legal and secretarial costs, expenditure to open a new facility or business (pre-opening costs) or expenditures for commencing new operations or launching new products or processes (pre-operating costs);

b. expenditure on training activities;

c. expenditure on advertising and promotional activities; and

d. expenditure on relocating or re-organising part or all of an enterprise.

The above guidance does not apply to payments for the delivery of goods or services made in advance of the delivery of goods or the rendering of services. Such prepayments are recognised as assets.

Past Expenses not to be recognised as an Asset

Expenditure on an intangible item that was initially recognised as an expense in previous annual financial statements or interim financial reports should not be recognised as part of the cost of an intangible asset at a later date.

6.18 SUBSEQUENT EXPENDITURE

Subsequent expenditure on an intangible asset after its purchase or its completion should be recognised as an expense when it is incurred unless:

a. It is probable that the expenditure will enable the asset to generate future economic benefits in excess of its originally assessed standard of performance and

b. The expenditure can be measured and attributed to the asset reliably.

If these conditions are met, the subsequent expenditure should be added to the cost of the intangible asset.

Subsequent expenditure on brands, mastheads, publishing titles, customer lists and items similar in substance is always recognised as an expense to avoid the recognition of internally generated goodwill.

The nature of intangible assets is such that, in many cases, it is not possible to determine whether subsequent expenditure is likely to enhance or maintain the economic benefits that will flow to the enterprise from those assets. Therefore, only rarely will expenditure incurred after the initial recognition of a purchased intangible asset or after completion of an internally generated intangible asset result in additions to the cost of the intangible asset.

6.19 MEASUREMENT SUBSEQUENT TO INITIAL RECOGNITION

After initial recognition, an intangible asset should be carried at its cost less any accumulated amortisation and any accumulated impairment losses.

6.20 AMORTISATION PERIOD

The depreciable amount of an intangible asset should be allocated on a systematic basis over the best estimate of its useful life. Amortisation should commence when the asset is available for use. Estimates of the useful life of an intangible asset generally become less reliable as the length of the useful life increases. AS 26 adopts a rebuttable presumption that the useful life of an intangible asset will not exceed ten years from the date when the asset is available for use. Amortisation is recognised whether or not there has been an increase in, for example, the asset's fair value or recoverable amount.

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Many factors need to be considered in determining the useful life of an intangible asset including:

a. the expected usage of the asset by the enterprise and whether the asset could be efficiently managed by another management team;

b. typical product life cycles for the asset and public information on estimates of useful lives of similar types of assets that are used in a similar way;

c. technical, technological or other types of obsolescence;

d. the stability of the industry in which the asset operates and changes in the market demand for the products or services output from the asset;

e. expected actions by competitors or potential competitors;

f. the level of maintenance expenditure required to obtain the expected future economic benefits from the asset and the company's ability and intent to reach such a level;

g. the period of control over the asset and legal or similar limits on the use of the asset, such as the expiry dates of related leases; and

h. whether the useful life of the asset is dependent on the useful life of other assets of the enterprise.

Given the history of rapid changes in technology, computer software and many other intangible assets are susceptible to technological obsolescence. Therefore, it is likely that their useful life will be short.

In some cases, there may be persuasive evidence that the useful life of an intangible asset will be a specific period longer than ten years. In these cases, the presumption that the useful life generally does not exceed ten years is rebutted and the enterprise:

a. Amortises the intangible asset over the best estimate of its useful life.

b. Estimates the recoverable amount of the intangible asset at least annually in order to identify any impairment loss and

c. Discloses the reasons why the presumption is rebutted and the factors that played a significant role in determining the useful life of the asset.

Example:

A. An enterprise has purchased an exclusive right to generate hydroelectric power for 60 years. The costs of generating hydro-electric power are much lower than the costs of obtaining power from alternative sources. It is expected that the geographical area surrounding the power station will demand a significant amount of power from the power station for at least 60 years.

The enterprise amortises the right to generate power over 60 years, unless there is evidence that its useful life is shorter.

B. An enterprise has purchased an exclusive right to operate a toll motorway for 30 years. There is no plan to construct alternative routes in the area served by the motorway. It is expected that this motorway will be in use for at least 30 years.

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The enterprise amortises the right to operate the motorway over 30 years, unless there is evidence that its useful life is shorter.

If control over the future economic benefits from an intangible asset is achieved through legal rights that have been granted for a finite period, the useful life of the intangible asset should not exceed the period of the legal rights unless the legal rights are renewable and renewal is virtually certain.

The useful life of an intangible asset may be very long but it is always finite.

There may be both economic and legal factors influencing the useful life of an intangible asset: economic factors determine the period over which future economic benefits will be generated; legal factors may restrict the period over which the enterprise controls access to these benefits. The useful life is the shorter of the periods determined by these factors.

Example:

Company X has purchased a copyright to produce a safety equipment for sale in the market. The rights have been obtained for 10 years. Hence, company is amortizing the intangible asset in 10 years. After 7 years, due to change in the environmental law, safety equipments produced out of new technology are only considered valid.

In above scenario, the company need to write off the balance amount in the year of implementation of the law.

6.21 AMORTISATION METHOD

The amortisation method used should reflect the pattern in which the asset's economic benefits are consumed by the enterprise. If that pattern cannot be determined reliably, the straight-line method should be used. A variety of amortisation methods can be used to allocate the depreciable amount of an asset on a systematic basis over its useful life. These methods include

- the straight-line method,
- the diminishing balance method and
- the unit of production method.

The method used for an asset is selected based on the expected pattern of consumption of economic benefits and is consistently applied from period to period, unless there is a change in the expected pattern of consumption of economic benefits to be derived from that asset.

The amortisation charge for each period should be recognised as an expense unless another Accounting Standard permits or requires it to be included in the carrying amount of another asset. For example, the amortisation of intangible assets used in a production process is included in the carrying amount of inventories.

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6.22 RESIDUAL VALUE

Residual value is the amount, which an enterprise expects to obtain for an asset at the end of its useful life after deducting the expected costs of disposal.

The residual value of an intangible asset should be assumed to be zero unless:

a. There is a commitment by a third party to purchase the asset at the end of its useful life or

b. There is an active market for the asset and:

  i. Residual value can be determined by reference to that market and

  ii. It is probable that such a market will exist at the end of the asset's useful life.

A residual value other than zero implies that an enterprise expects to dispose of the intangible asset before the end of its economic life.

6.23 REVIEW OF AMORTISATION PERIOD AND AMORTISATION METHOD

The amortisation period and the amortisation method should be reviewed at least at each financial year end. If the expected useful life of the asset is significantly different from previous estimates, the amortisation period should be changed accordingly. If there has been a significant change in the expected pattern of economic benefits from the asset, the amortisation method should be changed to reflect the changed pattern. Such changes should be accounted for in accordance with AS 5.

6.24 RECOVERABILITY OF THE CARRYING AMOUNT-IMPAIRMENT LOSSES

Impairment losses of intangible assets are calculated on the basis of AS 28. AS 28 "Impairment of Assets" is covered in next unit of this chapter.

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In addition to the requirements of Accounting Standard on Impairment of Assets, an enterprise should estimate the recoverable amount of the following intangible assets at least at each financial year end even if there is no indication that the asset is impaired:

a. an intangible asset that is not yet available for use; and

b. an intangible asset that is amortised over a period exceeding ten years from the date when the asset is available for use.

AS 26 requires an enterprise to test for impairment, at least annually, the carrying amount of an intangible asset that is not yet available for use.

Example:

X limited is developing a customized software for Rs.10 Cr. It will take 3 years to complete development. Present value of future economic benefit is considered to be Rs.15 Cr. After 2 years, 70% work is completed. However, due to change in market conditions, present value of future economic benefits are estimated to be Rs.6 Cr only.

Company should recognize Rs.1 Cr as impairment loss on "Intangible asset under development" as per AS 28. Only Rs.6 Cr can be shown as "Intangible asset under development". Company cannot capitalize any further amount till the time recoverable amount increases even if work of Rs.10 Cr is completed.

6.25 RETIREMENTS AND DISPOSALS

An intangible asset should be derecognised (eliminated from the balance sheet) if

- disposed or
- when no future economic benefits are expected from its use and subsequent disposal.

Gains or losses arising from the retirement or disposal of an intangible asset should be determined as the difference between the net disposal proceeds and the carrying amount of the asset and should be recognised as income or expense in the statement of profit and loss.

An intangible asset that is retired from active use and held for disposal is carried at its carrying amount at the date when the asset is retired from active use.

6.26 DISCLOSURE

The financial statements should disclose the following for each class of intangible assets, distinguishing between internally generated intangible assets and other intangible assets:

1. The useful lives or the amortisation rates used.
2. The amortisation methods used.
3. The gross carrying amount and the accumulated amortisation (aggregated with accumulated impairment losses) at the beginning and end of the period.
4. A reconciliation of the carrying amount at the beginning and end of the period showing:
   i. Additions, indicating separately those from internal development and through amalgamation.
   ii. Retirements and disposals.
   iii. Impairment losses recognised in the statement of profit and loss during the period.
   iv. Impairment losses reversed in the statement of profit and loss during the period.
   v. Amortisation recognised during the period and
   vi. Other changes in the carrying amount during the period.

A class of intangible assets is a grouping of assets of a similar nature and use in an enterprise's operations. Examples of separate classes may include:

a. brand names;
b. mastheads and publishing titles;
c. computer software;
d. licences and franchises;
e. copyrights, and patents and other industrial property rights, service and operating rights;

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f. recipes, formulae, models, designs and prototypes; and

g. intangible assets under development.

6.27 OTHER DISCLOSURES

The financial statements should also disclose:

a. If an intangible asset is amortised over more than ten years, the reasons why it is presumed that the useful life of an intangible asset will exceed ten years from the date when the asset is available for use. In giving these reasons, the enterprise should describe the factor(s) that played a significant role in determining the useful life of the asset.

b. A description, the carrying amount and remaining amortisation period of any individual intangible asset that is material to the financial statements of the enterprise as a whole.

c. The existence and carrying amounts of intangible assets whose title is restricted and the carrying amounts of intangible assets pledged as security for liabilities and

d. The amount of commitments for the acquisition of intangible assets.

The financial statements should disclose the aggregate amount of research and development expenditure recognised as an expense during the period.

An enterprise is encouraged, but not required, to give a description of any fully amortised intangible asset that is still in use.

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ILLUSTRATIONS

Illustration 1

ABC Ltd. developed know-how by incurring expenditure of Rs.20 lakhs, The know-how was used by the company from 1.4.20X1. The useful life of the asset is 10 years from the year of commencement of its use. The company has not amortised the asset till 31.3.20X8. Pass Journal entry to give effect to the value of know-how as per Accounting Standard-26 for the year ended 31.3.20X8.

Solution

Journal Entry

		Rs.	Rs.
Profit and Loss A/c (Prior period item)	Dr.	12,00,000	
Amortization A/c	Dr.	2,00,000	
To Know-how A/c∗ [Being amortization of 7 years (out of which amortization of 6 years charged as prior period item)]			14,00,000

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Illustration 2

The company had spent Rs.45 lakhs for publicity and research expenses on one of its new consumer product, which was marketed in the accounting year 20X1-20X2, but proved to be a failure. State, how you will deal with the following matters in the accounts of U Ltd. for the year ended 31st March, 20X2.

Solution

In the given case, the company spent Rs.45 lakhs for publicity and research of a new product which was marketed but proved to be a failure. It is clear that in future there will be no related further revenue/benefit because of the failure of the product. Thus, according to AS 26 ‘Intangible Assets’, the company should charge the total amount of Rs.45 lakhs as an expense in the profit and loss account.

Illustration 3

A company with a turnover of Rs.250 crores and an annual advertising budget of Rs.2 crores had taken up the marketing of a new product. It was estimated that the company would have a turnover of Rs.25 crores from the new product. The company had debited to its Profit and Loss account the total expenditure of Rs.2 crore incurred on extensive special initial advertisement campaign for the new product.

Is the procedure adopted by the company correct?

Solution

According to AS 26 'Intangible Assets', "expenditure on an intangible item should be recognised as an expense when it is incurred unless it forms part of the cost of an intangible asset".

AS 26 mentions that expenditure on advertising and promotional activities should be recognised as an expense when incurred.

In the given case, advertisement expenditure of Rs.2 crores had been taken up for the marketing of a new product which may provide future economic benefits to an enterprise by having a turnover of Rs.25 crores. Here, no intangible asset or other asset is acquired or created that can be recognised. Therefore, the accounting treatment by the company of debiting the entire advertising expenditure of Rs.2 crores to the Profit and Loss account of the year is correct.

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

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TEST YOUR KNOWLEDGE

MCQs

1. Which of the following is not covered within the scope of AS 26?

a. Intangible assets held-for-sale in the ordinary course of business

b. Assets arising from employee benefits

c. (a) & (b) both

d. Research and development activities

2. Intangible asset is recognised if it:

a. meets the definition of an intangible asset

b. is probable that future economic benefits will flow

c. the cost can be measured reliably

d. meets all of the above parameters

3. Sun Limited has purchased a computer with various additional software. These are integral part of the computer. Which of the following are true in the context of AS 26:

a. Recognise Computer and software as tangible asset

b. Recognise tangible and intangible separately

c. Recognise computer and software as intangible asset

d. Does not recognize the software as an asset.

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4. Hexa Ltd developed a technology to enhance the battery life of mobile devices. Hexa has capitalised development expenditure of Rs.5,00,000. Hexa estimates the life of the technology developed to be 3 years but the company has forecasted that 50% of sales will be in year 1, 35% in year 2 and 15% in year 3. What should be the amortisation charge in the second year of the product's life?

a. Rs.2,50,000

b. Rs.1,75,000

c. Rs.1,66,667

d. Rs.1,85,000

ANSWERS/SOLUTIONS

MCQs

1.	**c.**	(a) & (b) both
2.	**d.**	meets all of the above parameters
3.	**a.**	Recognise Computer and software as tangible asset
4.	**b.**	Rs.1,75,000

THEORETICAL QUESTIONS

Q.NO.1. What is meant by Intangible Assets and what are the important factors to consider the recognition of item as an Intangible asset? What is the recognition criteria in accordance with the provisions of AS 26?

ANSWER

An intangible asset is an identifiable non-monetary asset, without physical substance, held for use in the production or supply of goods or services, for rental to others, or for administrative purposes.

Below are the 3 key ingredients to be satisfied to cover an item as an intangible asset under this standard:

- identifiability,
- control over a resource and
- expectation (i.e. probable – 50% plus) of future economic benefits flowing to the enterprise.

The recognition of an item as an intangible asset requires an enterprise to demonstrate that the item meets the definition of an intangible asset and recognition criteria set out as below:

a. It is probable that the future economic benefits that are attributable to the asset will flow to the enterprise; and

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

Q.NO.2. What is the measurement criteria at the time of initial recognition of Intangible assets acquired through separate acquisition?

ANSWER

If an intangible asset is acquired separately, the cost of the intangible asset can usually be measured reliably. This is particularly so when the purchase consideration is in the form of cash or other monetary assets.

The cost of an intangible asset comprises:

- its purchase price,

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- any import duties and other taxes (other than those subsequently recoverable by the enterprise from the taxing authorities), and
- any directly attributable expenditure on making the asset ready for its intended use. Directly attributable expenditure includes, for example, professional fees for legal services.
- Any trade discounts and rebates are deducted in arriving at the cost.

Q.NO.3. What is the criteria for recognition and measurement of Internally generated intangible assets. Describe which kind of cost is considered for capitalisation with respect to provisions of AS 26. Whether the same applies for internally generated goodwill also?

ANSWER

To assess whether an internally generated intangible asset meets the criteria for recognition, an enterprise classifies the generation of the asset into 2 phases:

- Research Phase &
- Development Phase

Research Phase - The expenses related to Research phase is expensed off in statement of Profit and loss.

Development Phase - Development is the application of research findings or other knowledge to a plan or design for the production of new or substantially improved materials, devices, products, processes, systems or services prior to the commencement of commercial production or use.

An intangible asset arising from development (or from the development phase of an internal project) should be recognised if, and only if, an enterprise can demonstrate all of the conditions given in para 6.15.

Cost of an Internally Generated Intangible Asset

The cost of an internally generated intangible asset is the sum of expenditure incurred from the time when the intangible asset first meets the recognition criteria. Reinstatement of expenditure recognised as an expense in previous annual financial statements or interim financial reports is prohibited.

The cost of an internally generated intangible asset comprises all expenditure that can be directly attributed, or allocated on a reasonable and consistent basis, to creating, producing and making the asset ready for its intended use from the time when the intangible asset first meets the recognition criteria. For details, refer para 6.16.

Internally generated goodwill is not recognised as an asset because it is not an identifiable resource controlled by the enterprise that can be measured reliably at cost.

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Q.NO.4. Advise the complete accounting treatment for Research and development phase as per AS 26.

ANSWER

Research phase means acquisition of knowledge and Development phase means application of knowledge.

The expenditure related to Research phase is expensed off in statement of Profit and loss. However, the expenditure incurred in Development phase is capitalised as a cost of the internally generated intangible asset.

If an enterprise cannot distinguish the research phase from the development phase of an internal project to create an intangible asset, the enterprise treats the expenditure on that project as if it were incurred in the research phase only.

Q.NO.5. What is meant by Amortisation of an Intangible asset. What are the different methods for amortisation as per AS 26?

ANSWER

Amortisation is the systematic allocation of the depreciable amount of an intangible asset over its useful life.

The amortisation method used should reflect the pattern in which the asset's economic benefits are consumed by the enterprise. If that pattern cannot be determined reliably, the straight-line method should be used. A variety of amortisation methods can be used to allocate the depreciable amount of an asset on a systematic basis over its useful life. These methods include

- the straight-line method,
- the diminishing balance method and
- the unit of production method.

The method used for an asset is selected based on the expected pattern of consumption of economic benefits and is consistently applied from period to period, unless there is a change in the expected pattern of consumption of economic benefits to be derived from that asset.

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PRACTICAL QUESTIONS

Q.NO.1. Swift Ltd. acquired a patent at a cost of Rs.80,00,000 for a period of 5 years and the product life-cycle is also 5 years. The company capitalized the cost and started amortizing the asset at Rs.10,00,000 per annum. The company had amortized the patent at 10,00,000 per annum in first two years on the basis of economic benefits derived from the product manufactured under the patent. After two years it was found that the product life-cycle may continue for another 5 years from then. The patent was renewable and Swift Ltd. got it renewed after expiry of five years. The net cash flows from the product during these 5 years were expected to be Rs.36,00,000, Rs.46,00,000, Rs.44,00,000, Rs.40,00,000 and Rs.34,00,000. Find out the amortization cost of the patent for each of the years.

SOLUTION

Swift Limited amortised Rs.10,00,000 per annum for the first two years i.e. Rs.20,00,000. The remaining carrying cost can be amortised during next 5 years on the basis of net cash flows arising from the sale of the product. The amortisation may be found as follows:

S. No.	Net cash flows Rs.	Amortisation Ratio	Amortisation Amount Rs.
I	-	0.125	10,00,000
II	-	0.125	10,00,000
III	36,00,000	0.180	10,80,000
IV	46,00,000	0.230	13,80,000
V	44,00,000	0.220	13,20,000
VI	40,00,000	0.200	12,00,000
VII	34,00,000	0.170	10,20,000
Total	2,00,00,000	1.000	80,00,000

It may be seen from above that from third year onwards, the balance of carrying amount i.e., Rs.60,00,000 has been amortised in the ratio of net cash flows arising from the product of Swift Ltd.

Q.NO.2. AB Ltd. launched a project for producing product X in October, 20X1. The Company incurred Rs.20 lakhs towards Research. Due to prevailing market conditions, the Management came to conclusion that the product cannot be manufactured and sold in the market for the next 10 years. The Management hence wants to defer the expenditure write off to future years. Advise the Company as per the applicable Accounting Standard.

SOLUTION

As per para 41 of AS 26 "Intangible Assets", expenditure on research should be recognised as an expense when it is incurred. Hence, the expenses amounting Rs.20 lakhs incurred on the research has to be charged to the statement of profit and loss in the current year ending 31st March, 20X2.

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Q.NO.3. **During 20X1-X2, an enterprise incurred costs to develop and produce a routine low risk computer software product, as follows:**

Particular	Rs.
Completion of detailed program and design (Phase 1)	**50,000**
Coding and Testing (Phase 2)	**40,000**
Other coding costs (Phase 3 & 4)	**63,000**
Testing costs (Phase 3 & 4)	**18,000**
Product masters for training materials (Phase 5)	**19,500**
Packing the products (1,500 units) (Phase 6)	**16,500**

After completion of phase 2, it was established that the product is technically feasible for the market. You are required to state how the above referred cost to be recognized in the books of accounts.

SOLUTION

As per AS 26, costs incurred in creating a computer software product should be charged to research and development expense when incurred until technological feasibility/asset recognition criteria has been established for the product. Technological feasibility/asset recognition criteria have been established upon completion of detailed program design, coding and testing. In this case, Rs.90,000 would be recorded as an expense (Rs.50,000 for completion of detailed program design and Rs.40,000 for coding and testing to establish technological feasibility/asset recognition criteria). Cost incurred from the point of technological feasibility/asset recognition criteria until the time when products costs are incurred are capitalized as software cost (63,000+ 18,000+ 19,500) = Rs.1,00,500. Packing cost Rs.16,500 should be recognized as expenses and charged to P & L A/c.

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UNIT 7: ACCOUNTING STANDARD 28: IMPAIRMENT OF ASSETS

LEARNING OUTCOMES

After studying this unit, you will be able to:

- Define the terms 'recoverable amount', 'value in use', 'net selling price', 'cost of disposal', 'impairment loss' and other related terms.
- Identify an asset that may be Impaired.
- Measure the recoverable amount after computing net selling price and value in use
- Recognise and measure the impairment loss
- Identify the cash generating units
- Compute the recoverable amount and carrying amount of a cash generating unit
- Identify goodwill that whether it relates to the cash-generating unit
- Impair the cash generating unit
- Set out the requirements for reversing an impairment loss
- Apply impairment provisions in case of discontinuing operations

7.1 INTRODUCTION

AS 28 came into effect in respect of accounting period commenced on or after 1-4-2004 and is mandatory in nature from that date for the following:

i. Enterprises whose equity or debt securities are listed on a recognised stock exchange in India, and enterprises that are in the process of issuing equity or debt securities that will be listed on a recognised stock exchange in India as evidenced by the board of directors' resolution in this regard.

ii. All other commercial, industrial and business reporting enterprises, whose turnover for the accounting period exceeds Rs. 50 crores.

In respect of all other enterprises, the Accounting Standard came into effect in respect of accounting periods commenced on or after 1-4-2005 and is mandatory in nature from that date. This standard prescribes the procedures to be applied to ensure that the assets of an enterprise are carried at an amount not exceeding their recoverable amount (amount to be recovered through use or sale of the asset). The standard also lays down principles for reversal of impairment losses and prescribes certain disclosures in respect of impaired assets. An enterprise is required to assess at each balance sheet date whether there is an indication that an enterprise's assets may be impaired. If such an indication exists, the enterprise is required to estimate the recoverable amount and the impairment loss, if any, should be recognised in the profit and loss account.

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7.2 SCOPE

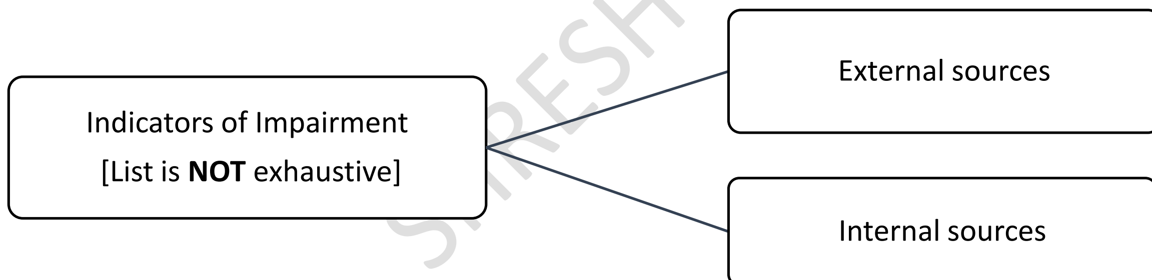
The standard should be applied in accounting for impairment of all assets except

1. inventories (AS 2),
2. assets arising under construction contracts (AS 7),
3. financial assets including investments covered under AS 13, and
4. deferred tax assets (AS 22).

There are chances that the provision on account of impairment losses may increase sickness of companies and potentially sick companies may actually become sick.

7.3 ASSESSMENT

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



<u>External sources of information</u>

a. During the period, an asset's market value has declined significantly more than would be expected as a result of the passage of time or normal use.
b. Significant changes with an adverse effect on the enterprise have taken place during the period, or will take place in the near future, in the technological, market, economic or legal environment in which the enterprise operates or in the market to which an asset is dedicated.
c. Market interest rates or other market rates of return on investments have increased during the period, and those increases are likely to affect the discount rate used in calculating an asset's value in use and decrease the asset's recoverable amount materially.
d. The carrying amount of the net assets of the reporting enterprise is more than its market capitalization.

Internal sources of information

a. Evidence is available of obsolescence or physical damage of an asset.

b. Significant changes with an adverse effect on the enterprise have taken place during the period, or are expected to take place in the near future, in the extent to which, or manner in which, an asset is used or is expected to be used. These changes include plans to discontinue or restructure the operation to which an asset belongs or to dispose of an asset before the previously expected date and

c. Evidence is available from internal reporting that indicates that the economic performance of an asset is, or will be, worse than expected.

An enterprise may identify other indications that an asset may be impaired and these would also require the enterprise to determine the asset's recoverable amount.

Example that indicates that an asset may be impaired because of the following:

a. cash flows for acquiring the asset, or subsequent cash needs for operating or maintaining it, that are significantly higher than those originally budgeted

b. actual net cash flows or operating profit or loss flowing from the asset that are significantly worse than those budgeted;

c. a significant decline in budgeted net cash flows or operating profit, or a significant increase in budgeted loss, flowing from the asset; or

d. operating losses or net cash outflows for the asset, when current period figures are aggregated with budgeted figures for the future.

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The concept of materiality applies in identifying whether the recoverable amount of an asset needs to be estimated.

Note: If there is an indication that an asset may be impaired, this may indicate that the **remaining useful life, the depreciation method or the residual value** for the asset need to be reviewed and adjusted under the Accounting Standard 10, **even if no impairment loss is recognised** for the asset.

7.4 MEASUREMENT OF RECOVERABLE AMOUNT

An impairment loss is the amount by which the carrying amount of an asset exceeds its recoverable amount.

Recoverable amount is the higher of an asset's net selling price and it's value in use.

Net selling price is the amount obtainable from the sale of an asset in an arm's length transaction between knowledgeable, willing parties, less the costs of disposal.

Costs of disposal are incremental costs directly attributable to the disposal of an asset, excluding finance costs and income tax expense. The best evidence for net selling price is a price in the bidding sales agreement for the disposal of the assets or similar assets. In the absence of this, net selling price is estimated from the transactions for the assets in active market, if the asset has the active market. If there is no binding sale agreement or active market for an asset, net selling price is based on the best information available to reflect the amount that an enterprise could obtain, at the balance sheet date, for the disposal of the asset in an arm's length transaction between knowledgeable, willing parties, after deducting the costs of disposal.

Value in Use is the present value of estimated future cash flows expected to arise from the continuing use of an asset and from its disposal at the end of its useful life.

Estimating the value in use of an asset involves the following steps:

a. Estimating the future cash inflows and outflows arising from continuing use of the asset and from its ultimate disposal; and

b. Applying the appropriate discount rate to these future cash flows.

Carrying amount is the amount at which an asset is recognised in the balance sheet after deducting any accumulated depreciation (amortisation) and accumulated impairment losses thereon.

Depreciation (Amortisation) is a systematic allocation of the depreciable amount of an asset over its useful life.

Depreciable amount is the cost of an asset, or other amount substituted for cost in the financial statements, less its residual value.

Useful life is either:

- The period of time over which an asset is expected to be used by the enterprise; or
- The number of production or similar units expected to be obtained from the asset by the enterprise.

Note 1: If there is no reason to believe that an asset's value in use materially exceeds its net selling price, the asset's recoverable amount may be taken to be its net selling price. This will often be the case for an asset that is held for disposal. Otherwise, if it is not possible to determine the selling price we take value in use of assets as it's recoverable amount.

It is not always necessary to determine both an asset's net selling price and its value in use. For example, if either of these amounts exceeds the asset's carrying amount, the asset is not impaired, and it is not necessary to estimate the other amount.

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It may be possible to determine net selling price, even if an asset is not traded in an active market. However, sometimes it will not be possible to determine net selling price because there is no basis for making a reliable estimate of the amount obtainable from the sale of the asset in an arm's length transaction between knowledgeable and willing parties. In this case, the recoverable amount of the asset may be taken to be its value in use.

Note 2: Recoverable amount is determined for an **individual asset,** unless the asset does not generate cash inflows from continuing use that are largely independent of those from other assets or groups of assets. If this is the case, recoverable amount is determined for the **cash-generating unit** to which the asset belongs, unless either:

a. The asset's net selling price is higher than its carrying amount; or

b. The asset's value in use can be estimated to be close to its net selling price and net selling price can be determined.

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7.5 BASIS FOR ESTIMATES OF FUTURE CASH FLOWS

Cash flow projections should be based on the most recent approved budgets/forecasts for a maximum of five years. Financial budgets/forecasts over a period longer than five years may be used if management is confident that these projections are reliable and it can demonstrate its ability, based on past experience, to forecast cash flows accurately over that longer period.

Cash flow projections until the end of an asset's useful life are estimated by extrapolating the cash flow projections based on the financial budgets/forecasts using a growth rate for subsequent years. This rate is steady or declining. This growth rate should not exceed the long-term average growth rate for the products, industries, or country or countries in which the enterprise operates, or for the market in which the asset is used, unless a higher rate can be justified.

Cash flow projections should be based on reasonable and supportable assumptions that represent management's best estimate of the set of economic conditions that will exist over the remaining useful life of the asset. Greater weight should be given to external evidence.

7.6 COMPOSITION OF ESTIMATES OF FUTURE CASH FLOWS

Estimates of future cash flows should include

i. Projections of net cash inflows from the continuing use of the asset

ii. projections of cash outflows that are necessarily incurred to generate the cash inflows from continuing use of the asset and that can be directly attributed, or allocated on a reasonable and consistent basis, to the asset; and

iii. Net cash flows, if any, to be received (or paid) for the disposal of the asset at the end of its useful life.

Care should be taken for the following points:

a. When the carrying amount of an asset does not yet include all the cash outflows to be incurred before it is ready for use or sale, estimate of any further cash outflow that is expected to be incurred before the asset is ready for use or sale should be included.

b. Cash inflows from assets that generate cash inflows from continuing use that are largely independent of the cash inflows from the asset under review should not be included.

c. Cash outflows that relate to obligations that have already been recognised as liabilities to be excluded.

d. Future cash outflows or inflows expected to arise because of restructuring of the organization should be not considered.

e. Any future capital expenditure enhancing the capacity of the assets and its related savings/outflow should be excluded.

f. Any increase in expected cash inflow from the above expenditure should also be excluded.

g. Estimates of future cash flows should not include cash inflows or outflows from financing activities and also income tax receipts or payments.

h. The estimate of net cashflow upon disposal of the asset should be the amount that an enterprise expects to obtain from the disposal of the asset in an arm's length transaction between knowledgeable, willing parties prevailing at the date of the estimates, after deducting the estimated costs of disposal.

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When an enterprise becomes committed to a restructuring, some assets are likely to be affected by this restructuring. Once the enterprise is committee to the restructuring, in determining value in use, estimates of future cash inflows and cash outflows reflect the cost savings and other benefits from the restructuring (based on the most recent financial budgets/forecasts that have been approved by management).

Foreign Currency Future Cash Flows are estimated in the currency in which it will be generated and then they are discounted for the time value of money using a discount rate appropriate for that currency. we convert cashflow in the reporting currency on the basis of AS 11.

Discount Rate

The discount rate(s) should be a pre-tax rate(s) that reflect(s) current market assessments of the time value of money and the risks specific to the asset. The discount rate(s) should not reflect risks for which future cash flow estimates have been adjusted.

A rate that reflects current market assessments of the time value of money and the risks specific to the asset is the return that investors would require if they were to choose an investment that would generate cash flows of amounts, timing and risk profile equivalent to those that the enterprise expects to derive from the asset.

When an asset-specific rate is not directly available from the market, an enterprise uses other bases to estimate the discount rate such as incremental borrowing rate, rate using capital asset pricing model, etc.

<u>These rates are adjusted:</u>

a. to reflect the way that the market would assess the specific risks associated with the projected cash flows; (Consideration is given to risks such as country risk, currency risk, price risk and cash flow risk) and

b. to exclude risks that are not relevant to the projected cash flows.

An enterprise normally uses a single discount rate for the estimate of an asset's value in use. However, an enterprise uses separate discount rates for different future periods where value in use is sensitive to a difference in risks for different periods or to the term structure of interest rates.

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7.7 RECOGNITION AND MEASUREMENT OF AN IMPAIRMENT LOSS

Case I:

If recoverable amount of assets more than carrying amount, we ignore the difference and asset is carried on at the same book value.

Note: As mentioned above, if there is an indication that an asset may be impaired, this may indicate that the remaining useful life, the depreciation method or the residual value for the asset need to be reviewed and adjusted under the Accounting Standard 10, even if no impairment loss is recognised for the asset.

Case II:

When this recoverable amount is less than the carrying amount, this difference termed as Impairment Loss.

Accounting implications:

Particulars	**Remarks**
Treatment of Impairment loss	It should be written off immediately as expenses to Profit & Loss Account. If assets are carried out at revalued figures then the impairment loss equivalent to revalued surplus is adjusted with it and the balance (if any) is charged to Profit & Loss Account.

Depreciation	Depreciation for the coming years on the assets are recalculated on the basis of the new carrying amount, residual value and remaining useful life of the asset, according to AS 10.

Case III:

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

7.8 IDENTIFICATION OF THE CASHGENERATING UNIT TO WHICH AN ASSET BELONGS

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

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

If recoverable amount cannot be determined for an individual asset, an enterprise identifies the lowest aggregation of assets that generate largely independent cash inflows from continuing use. Even if part or all of the output produced by an asset or a group of assets is used by other units of the reporting enterprise, this asset or group of assets forms a separate cash-generating unit if the enterprise could sell this output in an active market. This is because this asset or group of assets could generate cash inflows from continuing use that would be largely independent of the cash inflows from other assets or groups of assets. In using information based on financial budgets/forecasts that relates to such a cash generating unit, an enterprise adjusts this information if internal transfer prices do not reflect management's best estimate of future market prices for the cash generating unit's output.

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

Example 1

A mining enterprise owns a private railway to support its mining activities. The private railway could be sold only for scrap value and the private railway does not generate cash inflows from continuing use that are largely independent of the cash inflows from the other assets of the mine.

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

Example 2

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

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

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

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7.9 RECOVERABLE AMOUNT AND CARRYING AMOUNT OF A CASH-GENERATING UNIT

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

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

Example 3

A company operates a mine in a country where legislation requires that the owner must restore the site on completion of its mining operations. The cost of restoration includes the replacement of the overburden, which must be removed before mining operations commence. A provision for the costs to replace the overburden was recognised as soon as the overburden was removed. The amount provided was recognised as part of the cost of the mine and is being depreciated over the mine's useful life. The carrying amount of the provision for restoration costs is Rs. 50,00,000, which is equal to the present value of the restoration costs.

The enterprise is testing the mine for impairment. The cash-generating unit for the mine is the mine as a whole. The enterprise has received various offers to buy the mine at a price of around Rs.80,00,000; this price encompasses the fact that the buyer will take over the obligation to restore the overburden. Disposal costs for the mine are negligible. The value in use of the mine is approximately Rs. 1,20,00,000 excluding restoration costs. The carrying amount of the mine is Rs.1,00,00,000.

The net selling price for the cash-generating unit is Rs.80,00,000. This amount considers restoration costs that have already been provided for. As a consequence, the value in use for the cash-generating unit is determined after consideration of the restoration costs and is estimated to be Rs.70,00,000 (Rs. 1,20,00,000 less Rs. 50,00,000). The carrying amount of the cash-generating unit is Rs.50,00,000, which is the carrying amount of the mine (Rs. 1,00,00,000) less the carrying amount of the provision for restoration costs (Rs. 50,00,000).

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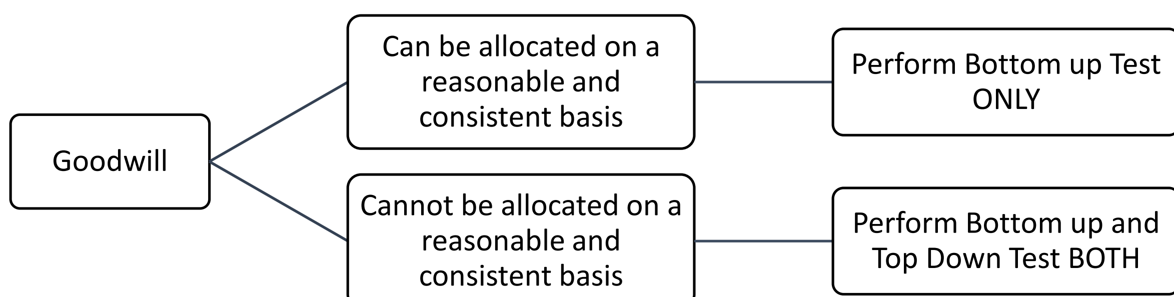
7.10 GOODWILL

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

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



Example:

At the end of 20X0, enterprise M acquired 100% of enterprise Z for Rs. 3,000 lakhs. Z has 3 cash-generating units A, B and C with net fair values of Rs. 1,200 lakhs, Rs. 800 lakhs and Rs. 400 lakhs respectively. M recognises goodwill of Rs. 600 lakhs (Rs. 3,000 lakhs less Rs. 2,400 lakhs) that relates to Z.

At the end of 20X4, A makes significant losses. Its recoverable amount is estimated to be Rs. 1,350 lakhs. Carrying amounts are detailed below (Rs. In Lakh).

End of 20X4	A	B	C	Goodwill	Total
Net carrying amount	1300	1200	800	120	3420

Scenario A - Goodwill Can be Allocated on a Reasonable and Consistent Basis

On the date of acquisition of Z, the net fair values of A, B and C are considered a reasonable basis for a pro-rata allocation of the goodwill to A, B and C.

Allocation of goodwill at the end of 20X4:

	A	B	C	Goodwill
End of 20X0				
Net fair values	1200	800	400	2400
Pro-Rata	50%	33%	17%	100%
End of 20X4				
Net carrying amount	1300	1200	800	3300
Allocation of goodwill	60	40	20	120
(Using pro rate above)				
Net carrying amount (After goodwill)	1360	1240	820	3420

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In accordance with the ‘bottom-up’ test in paragraph 78(a) of AS 28, M compares A’s recoverable amount to its carrying amount after the allocation of the carrying amount of goodwill:

End of 20X4	A (Rs. In Lakh)
Carrying amount after allocation of goodwill	1360
Recoverable amount	1350
Impairment loss	10

M recognises an impairment loss of Rs. 10 lakhs for A. The impairment loss is fully allocated to the goodwill in accordance with paragraph 87 of AS 28.

Scenario B - Goodwill Cannot be Allocated on a Reasonable and Consistent Basis

There is no reasonable way to allocate the goodwill that arose on the acquisition of Z to A, B and C.

At the end of 20X4, Z's recoverable amount is estimated to be Rs.3,400 lakhs.

At the end of 20X4, M first applies the 'bottom-up' test in accordance with paragraph 78(a) of this Statement. It compares A's recoverable amount to its carrying amount excluding the goodwill.

End of 20X4	A (Rs. In Lakh)
Carrying amount	1300
Recoverable amount	1350
Impairment loss	0

Therefore, no impairment loss is recognised for A as a result of the 'bottom-up' test.

Since the goodwill could not be allocated on a reasonable and consistent basis to A, M also performs a 'top-down' test in accordance with paragraph 78(b) of AS 28. It compares the carrying amount of Z as a whole to its recoverable amount (Z as a whole is the smallest cash-generating unit that includes A and to which goodwill can be allocated on a reasonable and consistent basis).

Application of the 'top-down' test (Amount in Rs. lakhs)

End of 20X4	A	B	C	Goodwill	Total
Carrying amount	1300	1200	800	120	3420
Impairment loss arising from the 'bottom-up' test	0	-	-	-	0
Carrying amount after the 'bottom-up' test	1300	1200	800	120	3420
Recoverable amount	-	-	-	-	3400
Impairment loss arising from 'top-down' test	-	-	-	-	20

Therefore, M recognises an impairment loss of Rs. 20 lakhs that it allocates fully to goodwill in accordance with paragraph 87 of AS 28.

7.11 CORPORATE ASSETS

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

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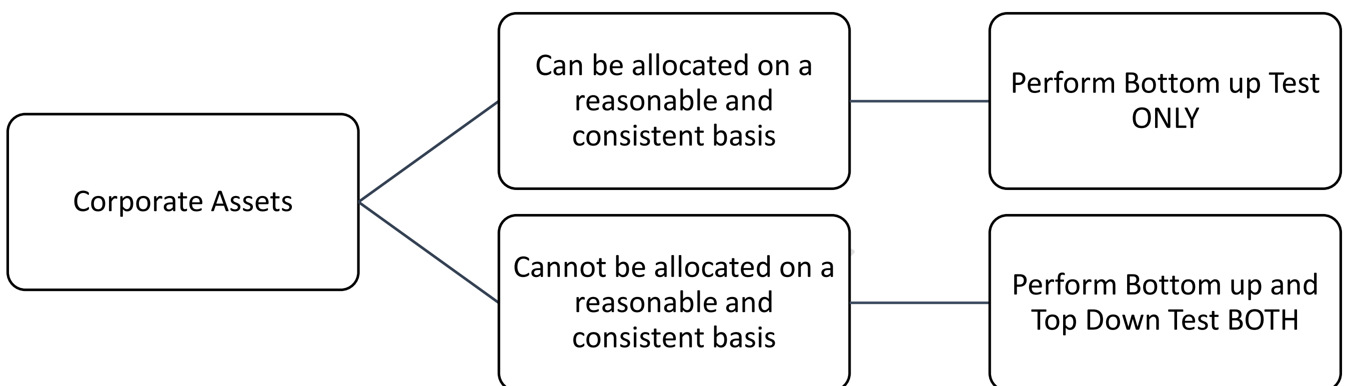
Examples

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

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

a. If the carrying amount of the corporate asset can be allocated on a reasonable and consistent basis to the cash-generating unit under review, an enterprise should apply the 'bottom-up' test only; and

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



7.12 IMPAIRMENT LOSS FOR A CASH GENERATING UNIT

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

a. First, to goodwill allocated to the cash-generating unit (if any); and

b. Then, to the other assets of the unit on a pro-rata basis based on the carrying amount of each asset in the unit.

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

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

a. Its net selling price (if determinable);

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

c. Zero.

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

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

Example 4

A machine has suffered physical damage but is still working, although not as well as it used to. The net selling price of the machine is less than its carrying amount. The machine does not generate independent cash inflows from continuing use. The smallest identifiable group of assets that includes the machine and generates cash inflows from continuing use that are largely independent of the cash inflows from other assets is the production line to which the machine belongs. There coverable amount of the production line shows that the production line taken as a whole is not impaired.

Assumption 1: Budgets/forecasts approved by management reflect no commitment of management to replace the machine.

a. The recoverable amount of the machine alone cannot be estimated since the machine's value in use: may differ from its net selling price; and

b. can be determined only for the cash-generating unit to which the machine belongs (the production line).

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

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Assumption 2: Budgets/forecasts approved by management reflect a commitment of management to replace the machine and sell it in the near future. Cash flows from continuing use of the machine until its disposal are estimated to be negligible.

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

7.13 REVERSAL OF AN IMPAIRMENT LOSS

An enterprise should assess at each balance sheet date whether there is any indication that an impairment loss recognised for an asset in prior accounting periods may no longer exist or may have decreased. If any such indication exists, the enterprise should estimate the recoverable amount of that asset. An impairment loss recognised for an asset in prior accounting periods should be reversed if there has been a change in the estimates of cash inflows, cash outflows or discount rates used to determine the asset's recoverable amount since the last impairment loss was recognised. If

this is the case, the carrying amount of the asset should be increased to its recoverable amount. That increase is a reversal of an impairment loss. Indications of a potential decrease in an impairment loss are mainly mirror the indications of a potential impairment loss discussed above as external and internal indicators. The concept of materiality applies in identifying whether an impairment loss recognised for an asset in prior accounting periods may need to be reversed and the recoverable amount of the asset determined.

7.14 REVERSAL OF AN IMPAIRMENT LOSS FOR AN INDIVIDUAL ASSET

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

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

Depreciation impact post reversal of impairment loss:

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

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7.15 REVERSAL OF AN IMPAIRMENT LOSS FOR A CASH-GENERATING UNIT

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

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

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

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

a. its recoverable amount (if determinable); and

b. the carrying amount that would have been determined (net of amortisation or depreciation) had no impairment loss been recognised for the asset in prior accounting periods.

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

7.16 REVERSAL OF AN IMPAIRMENT LOSS FOR GOODWILL

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

a. The impairment loss was caused by a specific external event of an exceptional nature that is not expected to recur; and

b. Subsequent external events have occurred that reverse the effect of that event.

7.17 IMPAIRMENT IN CASE OF DISCONTINUING OPERATIONS

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

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

a. If the enterprise sells the discontinuing operation substantially in its entirety, none of the assets of the discontinuing operation generate cash inflows independently from other assets within the discontinuing operation. Therefore, recoverable amount is determined for the discontinuing operation as a whole and an impairment loss, if any, is allocated among the assets of the discontinuing operation in accordance with this Statement;

b. If the enterprise disposes of the discontinuing operation in other ways such as piecemeal sales, the recoverable amount is determined for individual assets, unless the assets are sold in groups; and

c. If the enterprise abandons the discontinuing operation, the recoverable amount is determined for individual assets as set out in this Statement.

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

7.18 DISCLOSURE

For each class of assets, the financial statements should disclose:

a. The amount of impairment losses recognised in the statement of profit and loss during the period and the line item(s) of the statement of profit and loss in which those impairment losses are included;

b. The amount of reversals of impairment losses recognised in the statement of profit and loss during the period and the line item(s) of the statement of profit and loss in which those impairment losses are reversed;

c. The amount of impairment losses recognised directly against revaluation surplus during the period; and

d. The amount of reversals of impairment losses recognised directly in revaluation surplus during the period.

This information may be included in a reconciliation of the carrying amount of fixed assets, at the beginning and end of the period, as required under AS 10.

An enterprise that applies AS 17, Segment Reporting, should disclose the following for each reportable segment based on an enterprise's primary format (as defined in AS 17):

a. The amount of impairment losses recognised in the statement of profit and loss and directly against revaluation surplus during the period; and

b. The amount of reversals of impairment losses recognised in the statement of profit and loss and directly in revaluation surplus during the period.

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If an impairment loss for an individual asset or a cash-generating unit is recognised or reversed during the period and is material to the financial statements of the reporting enterprise as a whole, an enterprise should disclose:

a. The events and circumstances that led to the recognition or reversal of the impairment loss;

b. The amount of the impairment loss recognised or reversed;

c. For an individual asset:

  i. The nature of the asset; and

  ii. The reportable segment to which the asset belongs, based on the enterprise's primary format (as defined in AS 17, Segment Reporting);

d. For a cash-generating unit:

  i. A description of the cash-generating unit (such as whether it is a product line, a plant, a business operation, a geographical area, a reportable segment as defined in AS 17 or other);

  ii. The amount of the impairment loss recognised or reversed by class of assets and by reportable segment based on the enterprise's primary format (as defined in AS 17); and

iii. If the aggregation of assets for identifying the cash-generating unit has changed since the previous estimate of the cash-generating unit's recoverable amount (if any), the enterprise should describe the current and former way of aggregating assets and the reasons for changing the way the cash-generating unit is identified;

e. Whether the recoverable amount of the asset (cash-generating unit) is its net selling price or its value in use;

f. If recoverable amount is net selling price, the basis used to determine net selling price (such as whether selling price was determined by reference to an active market or in some other way); and

g. If recoverable amount is value in use, the discount rate(s) used in the current estimate and previous estimate (if any) of value in use.

If impairment losses recognised (reversed) during the period are material in aggregate to the financial statements of the reporting enterprise as a whole, an enterprise should disclose a brief description of the following:

a. The main classes of assets affected by impairment losses (reversals of impairment losses);

b. The main events and circumstances that led to the recognition (reversal) of these impairment losses.

An enterprise is encouraged to disclose key assumptions used to determine the recoverable amount of assets (cash-generating units) during the period.

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ILLUSTRATIONS

Illustration 1

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

Year	Cash Flow (Rs. in lakhs)
20X2	**4000**
20X3	**6000**
20X4	**6000**
20X5	**8000**
20X6	**4000**

Residual value at the end of 20X6 = Rs. 1000 lakhs

Property, Plant and Equipment purchased on 1-1-20XX = Rs. 40,000 lakhs

Useful life = 8 years

Net selling price on 31-12-20X1 = Rs. 20,000 lakhs

Calculate on 31-12-20X1:

a. Carrying amount at the end of 20X1

b. Value in use on 31-12-20X1

c. Recoverable amount on 31-12-20X1

d. Impairment loss to be recognized for the year ended 31-12-20X1

e. Revised carrying amount

f. Depreciation charge for 20X2.

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

Solution

Calculation of value in use

Year	Cash Flow	Discount as per 15%	Discounted cash flow
20X2	4,000	0.870	3,480
20X3	6,000	0.756	4,536
20X4	6,000	0.658	3,948
20X5	8,000	0.572	4,576
20X6	4,000	0.497	1,988
20X6	(residual) 1,000	0.497	497
			19,025

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a. **Calculation of carrying amount:**

Original cost = Rs. 40,000 lakhs

Depreciation for 3 years = [(40,000-1000)×3/8] = Rs. 14,625 lakhs

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

b. **Value in use = Rs. 19,025 lakhs**

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

Recoverable amount = Rs. 20,000 lakhs

d. **Impairment Loss = Rs. (25,375-20,000) = Rs. 5,375 lakhs**

e. **Revised carrying amount = Rs. (25,375-5,375) = Rs. 20,000 lakhs**

f. **Depreciation charge for 20X2** = (20,000-1000)/5 = Rs. 3,800 lakhs

Illustration 2

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

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

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

Solution

Present value of future cash flow

Year ended	Future Cash Flow	Discount @ 10% Rate	Discounted cash Flow
31.3.20X2	50	0.909	45.45
31.3.20X3	30	0.826	24.78
31.3.20X4	30	0.751	22.53
31.3.20X5	20	0.683	13.66
31.3.20X6	20	0.620	12.40
			118.82

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

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

Illustration 3

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

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Solution

Statement Showing Impairment Loss

	(Rs. in crores)
Carrying amount of the machine as on 1st April, 20X0	7.00
Depreciation for 4 years i.e. 20X0-20X1 to 20X3-20X	
$\left[\frac{7\text{crores}}{7\text{years}} \times 4\text{years}\right]$	(4.00)
Carrying amount as on 31.03.20X4	3.00
Add: Upward Revaluation (credited to Revaluation Reserve account)	2.10
Carrying amount of the machine as on 1st April, 20X4 (revalued)	5.10
Less: Depreciation for 2 years i.e. 20X4-20X5& 20X5-20X6	
$\left[\frac{5.10\text{crores}}{3\text{years}} \times 2\text{years}\right]$	(3.40)
Carrying amount as on 31.03.20X6	1.70
Less: Recoverable amount	(0.79)
Impairment loss	0.91

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

Illustration 4

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

Solution

Treatment of Impairment Loss

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

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

Working Note:

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

	(Rs. in lakhs)
Purchase price of a Property, Plant and Equipment	150.00
Less: Depreciation for four years [(150 lakhs / 10 years) x 4 years]	(60.00)

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Carrying value at the end of fourth year	90.00
Less: Downward revaluation charged to profit and loss account	(15.00)
Revalued carrying amount	75.00

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

SHRESHTA

TEST YOUR KNOWLEDGE

MCQs

1. If there is indication that an asset may be impaired but the recoverable amount of the asset is more than the carrying amount of the asset, the following are true:

a. No further action is required and the company can continue the asset in the books at the book value itself.

b. The entity should review the remaining useful life, scrap value and method of depreciation and amortization for the purposes of AS 10.

c. The entity can follow either (a) or (b).

d. The entity should review the scrap value and method of depreciation and amortization for the purposes of AS 10.

2. In case Goodwill appears in the Balance Sheet of an entity, the following is true:

a. Apply Bottom up test if goodwill cannot be allocated to CGU (cash generating unit) under review.

b. Apply Top down test if goodwill cannot be allocated to CGU (cash generating unit) under review.

c. Apply both Bottom up test and Top down test if goodwill cannot be allocated to CGU (cash generating unit) under review.

d. Apply either Bottom up test or Top down test if goodwill cannot be allocated to CGU (cash generating unit) under review.

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3. In case of Corporate assets in the Balance Sheet of an entity, the following is true:

a. Apply Bottom up test if corporate assets cannot be allocated to CGU (cash generating unit) under review.

b. Apply Top down test if corporate assets cannot be allocated to CGU (cash generating unit) under review.

c. Apply both Bottom up test and Top down test if corporate assets cannot be allocated to CGU (cash generating unit) under review.

d. Apply either Bottom up test or Top down test if corporate assets cannot be allocated to CGU (cash generating unit) under review.

4. In case of reversal of impairment loss, which statement is true:

a. Goodwill written off can never be reversed.

b. Goodwill written off can be reversed without any conditions to be met.

c. **Goodwill written off can be reversed only if certain conditions are met.**

d. **Goodwill written off can be reversed.**

ANSWERS/HINTS

MCQs

1.	**b.**	The entity should review the remaining useful life, scrap value and method of depreciation and amortization for the purposes of AS 10.
2.	**c.**	Apply both Bottom up test and Top down test if goodwill cannot be allocated to CGU (cash generating unit) under review.
3.	**c.**	Apply both Bottom up test and Top down test if corporate assets cannot be allocated to CGU (cash generating unit) under review.
4.	**c.**	Goodwill written off can be reversed only if certain conditions are met.

THEORY QUESTIONS

Q.NO.1. Write short note on impairment of asset and its application to inventory.

ANSWER

SHRESHTA

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

- If carrying amount < = Recoverable amount : Asset is not impaired
- If carrying amount > Recoverable amount : Asset is impaired

Impairment Loss = Carrying Amount – Recoverable Amount

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

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

PRACTICAL QUESTIONS

Q.NO.1. A publisher owns 150 magazine titles of which 70 were purchased and 80 were self-created. The price paid for a purchased magazine title is recognized as an intangible asset. The costs of creating magazine titles and maintaining the existing titles are recognized as an expense when incurred. Cash inflows from direct sales and advertising are identifiable for each magazine title. Titles are managed by customer segments. The level of advertising income for a magazine title depends on the range of titles in the customer segment to which the magazine title relates. Management has a policy to abandon old titles before the end of their economic lives and replace them immediately with new titles for the same customer segment. What is the cash-generating unit for an individual magazine title?

SOLUTION

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

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Q.NO.2. An asset does not meet the requirements of environment laws which have been recently enacted. The asset has to be destroyed as per the law. The asset is carried in the Balance Sheet at the year end at Rs. 6,00,000. The estimated cost of destroying the asset is Rs. 70,000. How is the asset to be accounted for?

SOLUTION

As per AS 28 “Impairment of Assets”, impairment loss is the amount by which the carrying amount of an asset exceeds its recoverable amount, where recoverable amount is the higher of an asset’s net selling price∗ and its value in use. In the given case, recoverable amount will be nil [higher of value in use (nil) and net selling price (negative Rs. 70,000)]. Thus impairment loss will be calculated as Rs. 6,00,000 [carrying amount (Rs. 6,00,000) – recoverable amount (nil)]. Therefore, asset is to be fully impaired and impairment loss of Rs. 6,00,000 has to be recognized as an expense immediately in the statement of Profit and Loss as per para 58 of AS 28.

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

Q.NO.3. **Venus Ltd. has a fixed asset, which is carried in the Balance Sheet on 31.3.20X1 at Rs. 500 lakhs. As at that date the value in use is Rs. 400 lakhs and the net selling price is Rs. 375 lakhs. From the above data:**

i. Calculate impairment loss.

ii. Prepare journal entries for adjustment of impairment loss.

iii. Show, how impairment loss will be shown in the Balance Sheet.

SOLUTION

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

Recoverable amount = Rs. 400 lakhs

Impairment loss = Carried Amount – Recoverable amount

= Rs. 500 lakhs – Rs. 400 lakhs = Rs. 100 lakhs.

ii. Journal Entries

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

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

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

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Q.NO.4. Good Drugs and Pharmaceuticals Ltd. acquired a sachet filling machine on 1st April, 20X1 for Rs.60 lakhs. The machine was expected to have a productive life of 6 years. At the end of financial year 20X1-20X2 the carrying amount was Rs.41 lakhs. A short circuit occurred in this financial year but luckily the machine did not get badly damaged and was still in working order at the close of the financial year. The machine was expected to fetch Rs.36 lakhs, if sold in the market. The machine by itself is not capable of generating cash flows. However, the smallest group of assets comprising of this machine also, is capable of generating cash flows of Rs.54 crore per annum and has a carrying amount of Rs.3.46 crore. All such machines put together could fetch a sum of Rs.4.44 crore if disposed. Discuss the applicability of Impairment loss.

SOLUTION

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

SHRESHTA

Q.NO.5. From the following details of an asset (i) Find out impairment loss (ii) Treatment of impairment loss (iii) Current year depreciation Particulars of asset:

Cost of asset	**Rs. 56 lakhs**
Useful life period	**10 years**
Salvage value	**Nil**
Current carrying value	**Rs. 27.30 lakhs**
Useful life remaining	**3 years**
Recoverable amount	**Rs. 12 lakhs**
Upward revaluation done in last year	**Rs. 14 lakhs**

SOLUTION

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

Impairment Loss and its treatment	**Rs.**
Current carrying amount (including revaluation amount of Rs.14 lakhs)	27,30,000

Less: Current recoverable amount	(12,00,000)
Impairment Loss	15,30,000
Impairment loss charged to revaluation reserve	14,00,000
Impairment loss charged to profit and loss account	1,30,000

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

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

Q.NO.6. A plant was acquired 15 years ago at a cost of Rs. 5 crores. Its accumulated depreciation as at 31st March, 20X1 was Rs. 4.15 crores. Depreciation estimated for the financial year 20X1-20X2 is Rs. 25 lakhs. Estimated Net Selling Price as on 31st March, 20X1 was Rs. 30 lakhs, which is expected to decline by 20 percent by the end of the next financial year. Its value in use has been computed at Rs. 35 lakhs as on 1st April, 20X1, which is expected to decrease by 30 per cent by the end of the financial year.

SHRESHTA

- **i. Assuming that other conditions for applicability of the impairment Accounting Standard are satisfied, what should be the carrying amount of this plant as at 31st March, 20X2?**
- **ii. How much will be the amount of write off for the financial year ended 31st March, 20X2?**
- **iii. If the plant had been revalued ten years ago and the current revaluation reserves against this plant were to be Rs. 12 lakhs, how would you answer to questions (i) and (ii) above?**
- **iv. If the value in use was zero and the enterprise were required to incur a cost of Rs. 2 lakhs to dispose of the plant, what would be your response to questions (i) and (ii) above?**

SOLUTION

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

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

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

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Working Note:

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

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

THE END