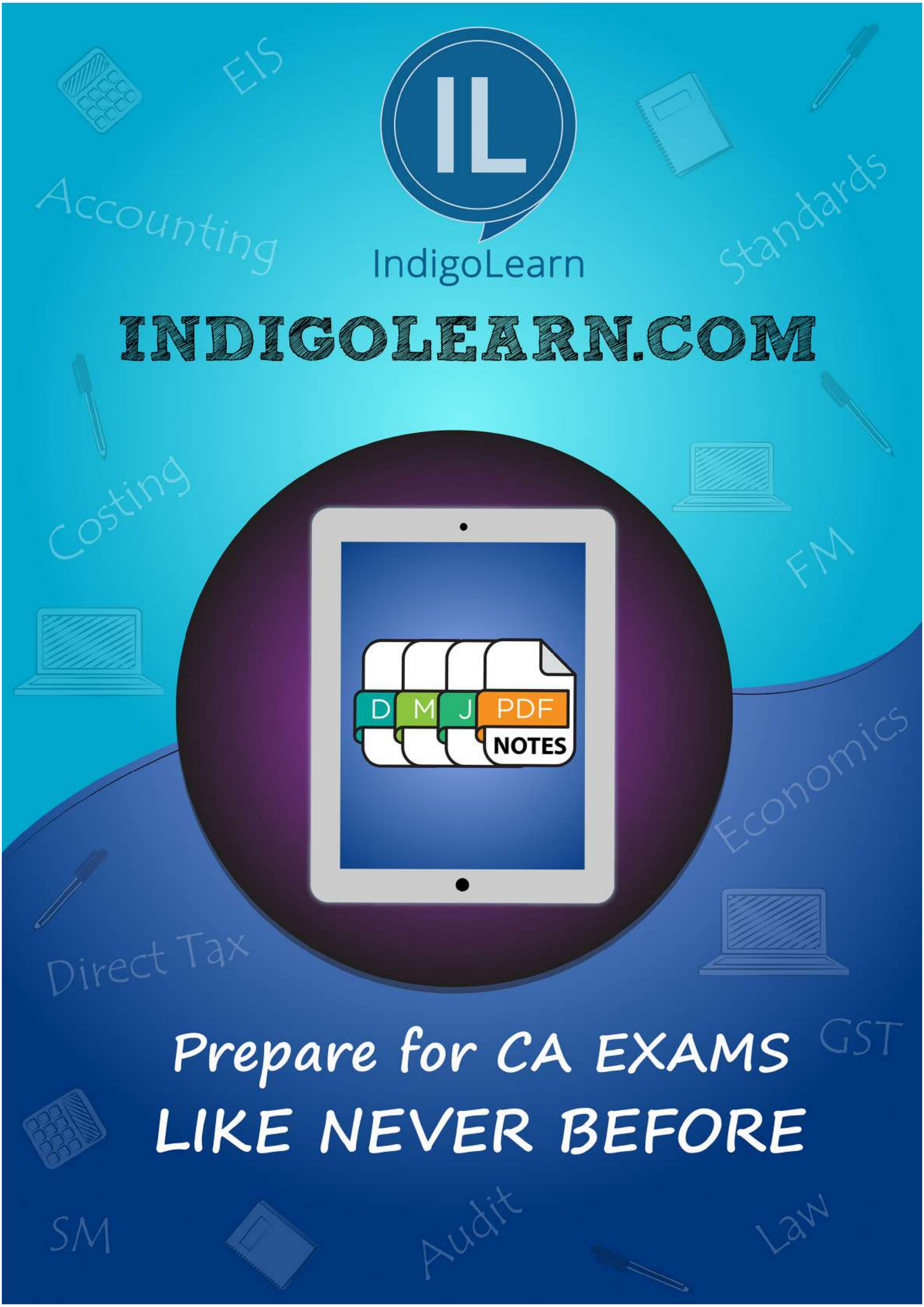

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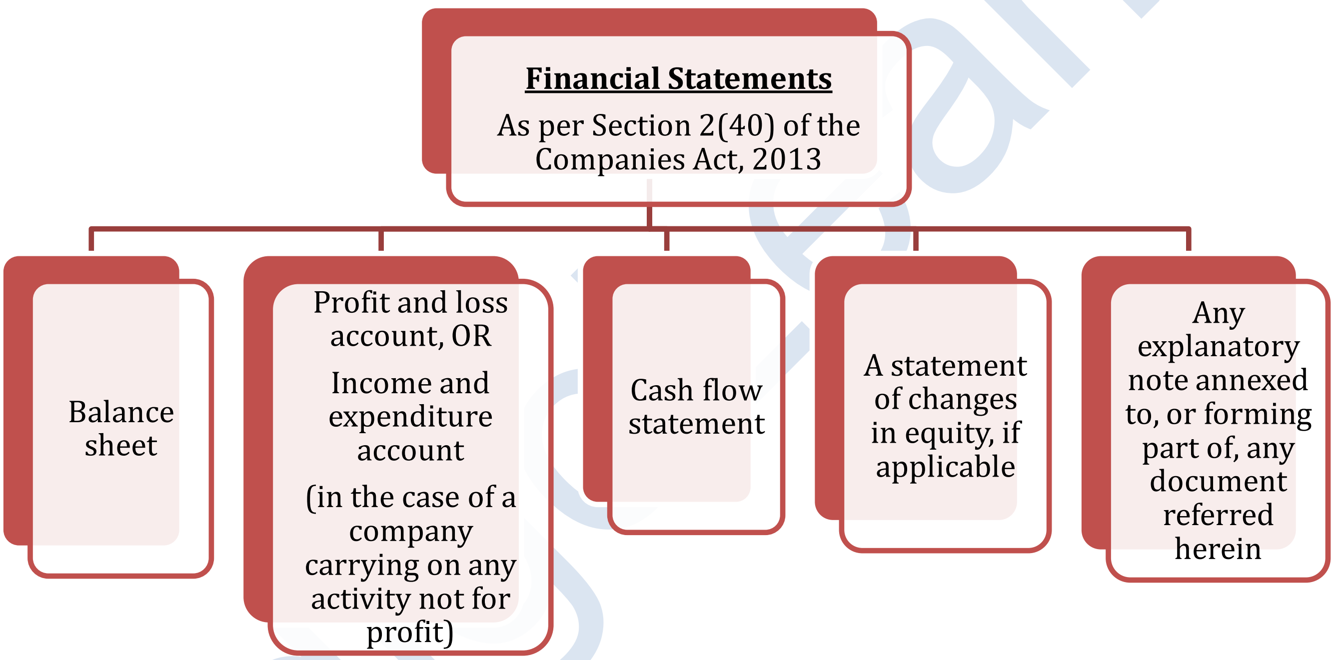
Table of content:

FRAMEWORK FOR PREPARATION AND PRESENTATION OF FINANCIAL STATEMENTS

FINAL ACCOUNTS

★ **Section 129 of the Companies Act, 2013** - At the AGM(Annual General Meeting) of a company, the Board of Directors of the company should lay financial statements before the company



The financial statement, with respect to One Person Company, Small company and Dormant company, does not include the cash flow statement.

★ **Objective of financial statements -** It should give a true and fair view of the state of affairs of the company as at the end of the financial year.

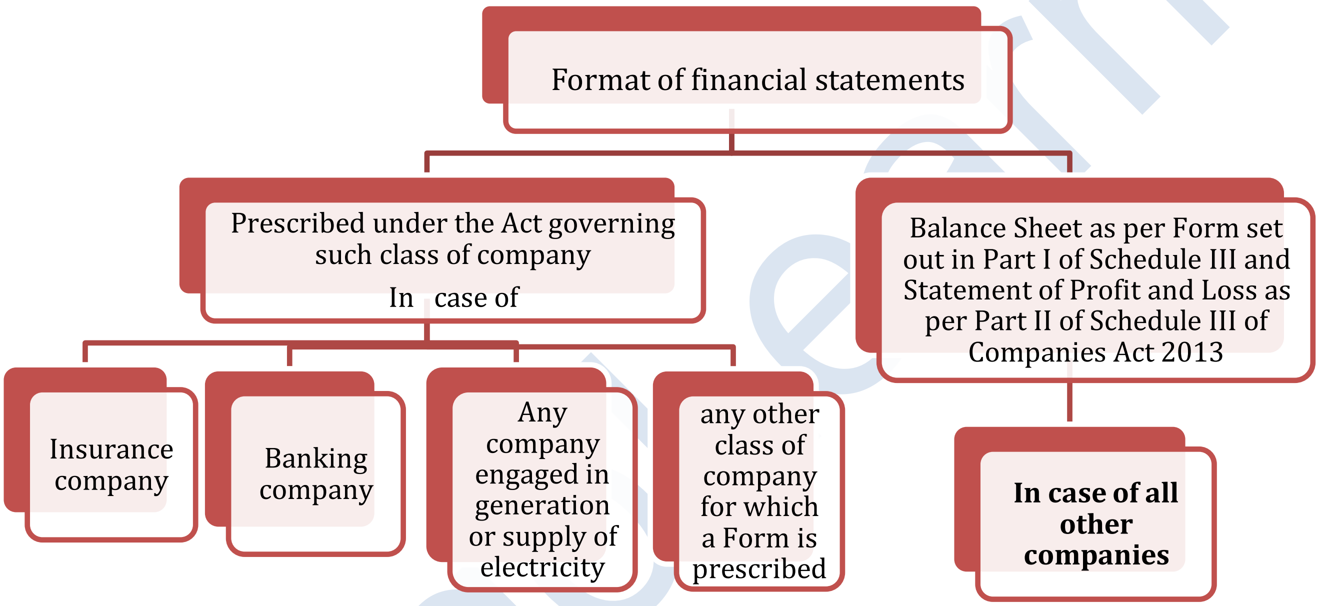
★ **Points to be kept in mind while preparing final accounts**

- Requirements of Schedule III to the Companies Act
- Other statutory requirements;
- Accounting Standards notified by Ministry of Corporate Affairs (MCA)(AS 1 to AS

29);

➢ Statements and Guidance Notes issued by the Institute of Chartered Accountants of India (ICAI); which are necessary for understanding the accounting treatment/ valuation/ disclosure suggested by the ICAI

★ **<u>Section 133 of the Companies Act -</u>** It is mandatory to comply with accounting standards notified by the Central Government from time to time.



PART-I - FORM OF BALANCE SHEET

Name of the Company: ....

Balance Sheet as at: ....

Sr.No.	Particulars	Note no.	Figure as at the end of Current reporting Period	Figures as at the end of the Previous Reporting Period
I	**Equity and Liabilities**			
1	Shareholders' Funds			
	(a) Share Capital (b) Reserves & Surplus (c) Money received against Share			

	Warrants			
2	Share application money pending allotment			
3	Non-Current liabilities			
	(a) Long-term Borrowings (b) DTL (Net) (c) Other long-term liabilities (d) Long-term Provisions			
4	Current liabilities			
	(a) Short-term Borrowings (b) Trade Payables (c) Other Current liabilities (d) Short-term Provisions			
	TOTAL			
II	**Assets**			
1	Non-Current assets			
	(a) PPE (property, plant & Equipment) (i) Tangible assets (ii) Intangible assets (iii) Capital WIP (iv) Intangible assets under development			
	(b) Non-Current investments (c) Deferred tax assets (DTA) (Net) (d) Long-term loans & advances (e) Other Non-Current assets			
2	Current assets			
	(a) Current investments (b) Inventories (c) Trade receivables (d) Cash & Cash equivalents (e) Short-term loans & advances (f) Other Current assets			
	TOTAL			

DISCLOSURE REQUIREMENTS IN RESPECT OF BALANCE SHEET

The disclosure requirements and the points to be kept in mind with regard to each of the above items is as follows:

1. SHARE CAPITAL

(a) Authorized Capital – to be shown separately

- It is the maximum number and face/par value, of each class of shares that a corporate entity may issue in accordance with its instrument of incorporation.
- Face/Par Value, as per Capital Clause in Memorandum of association should be disclosed.
- Separate disclosure for both Equity and Preference Shares.

(b) Number of Shares issued, Subscribed and Fully Paid, and Subscribed but not Fully Paid

- Subscribed Share Capital" is "that portion of the issued Share Capital which has actually been subscribed by the public and subsequently allotted to the shareholders by the entity. This also includes any Bonus shares issued to the Shareholders.
- "Paid-up Share Capital" is "that part of the Subscribed Share Capital for which consideration is cash or otherwise has been received. This also includes Bonus Shares allotted and Shares issued otherwise than for cash against purchase consideration, by the corporate entity."
- If Shares are not fully called, then disclose the called up value per share.
- Separate disclosure for both Equity and Preference Shares, which should again be sub-classified and represented for each class of Shares.

(c)Rights, Preferences and restrictions attaching to shares including restrictions on the distribution of dividends and the repayment of Capital

- All such Rights, Preferences and Restrictions attached to each class of Shares, terms of redemption, etc., should be disclosed separately.
- Further, Preference Shares can be cumulative, non-cumulative, redeemable, convertible, non-convertible, etc

(d) Disclose number of Shares held by the entire chain of Subsidiaries and associates starting from the Holding Company and ending right up to the ultimate Holding Company.

- All such disclosures should be made separately representing for each class of Shares, (for both equity and Preference Shares).

(e) List of Shareholders holding more than 5% shares as on the Balance Sheet date

- If during the year, any Shareholder held more than 5% equity Shares but does not hold as much at the Balance Sheet date, disclosure is not required.
- Companies should disclose the Shareholding for each class of Shares, both within equity and Preference Shares. So, such% should be computed separately for each class of Shares.
- This information should also be given for comparative previous period.

(g) Shares reserved for issue under Options and Contracts/ commitments for the sale of Shares/ disinvestment, including the terms and amounts

- Shares under Options generally arise under Promoters or Collaboration agreements, loan agreements or debenture deeds (including Convertible debentures), agreement to convert Preference Shares into equity Shares, ESOPs or Contracts for supply of Capital Goods, etc.
- Disclosure is required for the Number of Shares, amounts and Other terms for Shares so reserved.
- Such options are in respect of unissued Portion of Share Capital

(h) For the period of 5 years immediately preceding the date as at which the Balance Sheet is prepared-
• Aggregate Number & Class of Shares allotted as Fully Paid and up Pursuant to Contract(s) without payment being received in Cash
• Aggregate No. and Class of Shares allotted as fully Paid up by way of Bonus Shares
• Aggregate Number & Class of Shares bought back

- Disclose only if such event has occurred during a period of 5 years immediately preceding the Current year Balance Sheet date
- If the company is in operation for a period of less than 5 years, then disclosure should cover all such earlier financial years
- The following allotments are considered as Shares allotted for payment being received in cash, and hence should not be disclosed under this Clause –
  (a) If the subscription amount is adjusted against a bonafide debt payable in money at once by the Company,
  (b)Conversion of loan into Shares in the event of default in repayment

(i) Terms of any Securities Convertible into Equity / Preference Shares issued along with the earliest date of conversion in descending order starting from the farthest such date.

- In case of Compulsorily Convertible Securities, where conversion is done in fixed tranches, all the dates of conversion have to be considered.
- In case of Convertible Debentures/Bonds, etc., for the purpose of simplification, reference may also be made to the terms disclosed under the note on long term Borrowings where these are required to be classified in the Balance Sheet, rather than disclosing the same against under this Clause.

(j) Calls Unpaid (showing aggregate value of Calls Unpaid by Directors and Officers)

- Unpaid amount towards Shares subscribed by the Subscribers of Memorandum of association should be considered as 'Subscribed and paid-up Capital' in the Balance Sheet and the debts due from the Subscribers should be appropriately disclosed as an asset in the B/Sheet.

(l) Forfeited Shares (amount originally paid up)

2. RESERVES & SURPLUS

Reserves & Surplus shall be classified as –
(a) Capital reserves
(b) Capital redemption reserve
(c) Securities Premium
(d) Debenture redemption reserve
(e) Revaluation reserve
(f) Share Options Outstanding account
(g) Other reserves
(h) Surplus, i.e., balance in Statement of P&L disclosing allocations & appropriations, such as, dividend, Bonus Shares and transfer to/from reserves, etc.

- Additions & deductions since last Balance Sheet to be shown under each of specified heads.
- Appropriations to the Profit for the year (including carried forward balance) is to be presented under the main head 'Reserves and Surplus'.
- Under Sch III, the Statement of P&L will no longer reflect any appropriations, like Dividends transferred to reserves, Bonus Shares, etc.
- A Reserve specifically represented by Earmarked Investments shall be termed as a 'Fund'.
- Debit Balance Statement of P&L shall be shown as a Negative Figure under the head 'Surplus'. Similarly, the balance of 'reserves & Surplus', after adjusting Negative balance of Surplus, if any, shall be shown under the head 'Reserves & Surplus' even if the resulting figure is in the negative.

- **Capital Reserve -** It is a Reserve of a Corporate enterprise which is not available for distribution as dividend.
  Profit on Re-issue of Forfeited Shares is basically profit of a Capital Nature and, hence, it should be credited to Capital reserve.
- **Capital redemption reserve (CRR)** is required to be created u/s 55 and 68 (for redemption of Preference Share Capital and buyback of Equity Share Capital), subject to conditions specified in the respective Sections.
- **Debenture Redemption Reserve (DRR)** is required to be created u/s 71, and maintained until such debentures are redeemed. On redemption of the debentures, the amounts no longer necessary to be retained in this account should be transferred to the General reserve.
- **Revaluation reserve** is a reserve created on the revaluation of assets or Net assets of an enterprise represented by the surplus of the estimated Replacement Cost or estimated market values over the Book Values thereof.
- As per ICAI Guidance Note on ESOP, **Share Options Outstanding** should be shown as separate line item. Under Schedule III, this line item should be shown separately

under reserves & Surplus.

- **Other reserves** - This includes any other Statutory reserves, e.g. tonnage tax reserve to be created under the income tax act, 1961.

3. MONEY RECEIVED AGAINST SHARE WARRANTS

This is to be shown as a separate line item on the face of Balance Sheet. Since Shares are yet to be allotted against the same, these are not reflected as a part of Share Capital, but as a separate line-item.

4. SHARE APPLICATION MONEY PENDING ALLOTMENT

- Share application Money not exceeding the issued capital and to the extent not refundable is to be disclosed as a separate line item after “Share Holders Funds” and before “Non-Current Liabilities”.
- If the Company’s issued Capital is more than the authorized Capital, and approval of increase in authorized Capital is pending, the amount of Share application Money received over and above the authorized Capital should be shown under the head “Other Current Liabilities”.
- The amount shown as ‘Share application Money Pending allotment’ will not include Share application Money to the extent refundable, for example, the amount in excess of issued Capital, or where Minimum Subscription requirement is not met. Such amount will have to be shown separately under ‘Other Current liabilities.
- Calls Paid in Advance are to be shown under “Other Current liabilities”. the amount of interest which may accrue on such advance should also is to be reflected as a liability.

5. NON-CURRENT LIABILITIES

(A) LONG-TERM BORROWINGS

Long-Term Borrowings shall be classified as –

a) Bonds/debentures,
b) Terms Loans – (i) from Banks, and (ii) from Other Parties,
c) Deferred Payment liabilities,
d) Deposits,
e) Loans & advances from related Parties,
f) Long-term Maturities of Finance lease Obligations,
g) Other loans & advances (specify nature)

1. Definitions and Meanings:

- Loans with repayment period beyond 36 months are usually known as "**Term Loans**". So, Cash Credit, Overdraft and Call Money accounts/ deposits are not covered by the expression "Term Loans".
- **Deferred Payment liabilities** would include any liability for which payment is to be made on deferred credit terms, e.g., Deferred Sales tax liability, Deferred Payment for Acquisition of fixed Assets, etc.
- **Deposits** classified under Borrowings would include deposits accepted from Public and inter-Corporate deposits which are in the nature of Borrowings.
- **Loans and advances** from related parties are required to be disclosed. advances under this head should include those advances which are in the nature of loans.

2. Security-wise Classification:

- Borrowings shall further be sub-classified as Secured and Unsecured. Nature of Security shall be specified separately in each case.
- However, where one security is given for multiple loans, the same may be clubbed together for disclosure purposes with adequate details of cross referencing.
- Disclosure about the nature of security should also cover the type of asset given as security, e.g., Inventories, Plant and Machinery, land and Building, etc.
- When Promoters, other Shareholders or any third party have given any personal security for any borrowing, e.g., Shares or Other assets held by them, disclosure should be made thereof, though such security does not result in the classification of such borrowing as secured.

3. Guarantees:

- Where loans have been guaranteed by directors or Others, the aggregate amount of such
  loans under each head shall be disclosed.
- Others" would mean any Person or entity other than a director, e.g., related Parties, or any person associated with the Company in some manner.

4. Maturity Date wise:

- Bonds / debentures (along with rate of interest & particulars of redemption or Conversion, as the case may be) shall be stated in descending order of maturity or conversion, starting from farthest redemption or Conversion date, as the case may be.
- Current Maturities of all Long-Term Borrowings will be disclosed under "Other Current Liabilities" and not under long-term Borrowings and Short-term Borrowings.
- So, it is possible that the same Bonds/Debentures/ Term Loans may be bifurcated

under both "Long-term Borrowings" as well as under "Other Current liabilities".
5. Installment redemption: ➢ Where Bonds/ debentures are redeemable by installments, the date of Maturity for the purpose must be reckoned as the date on which the First installment becomes due.
6. Power to reissue: ➢ Particulars of any redeemed Bonds/debentures which the Company has power to reissue shall be disclosed.
7. Terms of repayment: ➢ Repayment of term loans and Other loans shall be stated. ➢ Disclosure of terms of repayment should be made preferably for each loan unless the repayment terms of individual loans within a category are similar, in which case, they may be aggregated.
8. Continuing Default: ➢ Period and amount of continuing default as on the Balance Sheet date in repayment of loans and interest, shall be specified separately in each case. ➢ The term "Continuing Default" is used w.r.t. Long Term Borrowings, whereas the term "Default" is used w.r.t. Short-term borrowings. ➢ Under CARO, the Auditor shall report on the default made and the period of default. ➢ Defaults other than in respect of repayment of loan and interest, e.g., non-compliance with debt Covenants, etc., need not be disclosed. ➢ Any default that had occurred during the year and was subsequently made good before the end of the year need not be disclosed.

(B) DEFERRED TAX LIABILITIES
➢ To be shown as a separate line item on the face of Balance Sheet.

(C) OTHER LONG-TERM LIABILITIES
It shall be classified as – (a) Trade Payables (b) Others
➢ Sundry Creditors for Goods or Services, and acceptances should be disclosed as part of trade Payables. ➢ Disclosure requirements under Micro, Small & Medium enterprises development (MSMED) act will also be required to be made in the annual Financial Statements. ➢ Amounts due under contractual obligations, e.g., payables in respect of statutory

obligations, like contribution to Provident Fund, Purchase of Fixed assets, Contractually reimbursable expenses, interest accrued on trade Payables, etc., should be classified as "Others" and each such item should be disclosed nature wise.

(D) LONG-TERM PROVISIONS

It shall be classified as –
(a) Provision for Employee Benefits
(b) Others (Specifying nature)

- This should be classified into short-term and long-term portions, and the latter amount should be included here.
- "Others" would include items like Provisions for Warranties.

(6) CURRENT LIABILITIES

(A) SHORT-TERM BORROWINGS

Short-Term Borrowings shall be classified as –
(a) Loans Repayable on demand– (i) from Banks, & (ii)Other Parties,
(b) Loans and Advances from Related Parties,
(c) Deposits,
(d) Other Loans and Advances (specify nature)

1. Definition & meaning:

- Short-Term Borrowings will include all Loans within a period of 12 months from the date of the loan, loans payable on demand, etc., but they will not include Current Maturity of long-term Borrowings (which should be treated only as "Other Current Liabilities").
- In case of Short-Term Borrowings, all defaults (not continuing defaults as in the case of long-term Borrowings) existing as at the date of the Balance Sheet should be disclosed (item wise)
- A 3-Year Loan taken for a business with a 4-year Operating Cycle will be categorized only as Short term Borrowings, and not as long-term Borrowings.

2. Security wise Classification:

- Borrowings shall further be sub-classified as Secured and Unsecured.
- Nature of security shall be specified separately in each case.

3. Guarantees:

- Where loans have been guaranteed by directors or others, the aggregate amount of such loans under each head shall be disclosed.

4. Default:

- Period & amount of default as on B/Sheet date in repayment of loans and interest shall be separately in each case.

(B) TRADE PAYABLES

It shall be classified as –

(a) Total outstanding dues of micro enterprises and small enterprises; and

(b) Total outstanding dues of creditors other than micro enterprises and small enterprises."

- Liability for Capital goods Purchases: Amount due towards purchase disclosed under "Other Current liabilities" with a suitable description.
- Liability under Contractual Obligations: Liability towards employees, leases or other Contractual liabilities should not be included under trade Payables.
- Only "Commercial Dues" can be included under trade Payables.

The following details relating to Micro, Small and Medium enterprises shall be disclosed in the notes:

(a) the principal amount and the interest due thereon (to be shown separately) remaining unpaid to any supplier at the end of each accounting year;

(b) the amount of interest paid by the buyer along with the amount of the payment made to the supplier beyond the appointed day during each accounting year;

(c) The amount of interest due and payable for the period of delay in making payment (which have been paid but beyond the appointed day during the year) but without adding the interest specified under the Micro, Small and Medium enterprises development act, 2006;

(d) the amount of interest accrued and remaining unpaid at the end of each accounting year; and

(e) the amount of further interest remaining due and payable even in the succeeding years, until such date when the interest dues above are actually paid to the small enterprise, for the purpose of disallowance of a deductible expenditure under Section 23 of the Micro, Small and Medium enterprises development act, 2006.

(C) OTHER CURRENT LIABILITIES

It shall be classified as –

(a) Current maturities of long-term debt,

(b) Current Maturities of Finance lease Obligations,

(c) interest accrued but not due on Borrowings,

(d) interest accrued and due on Borrowings,

(e) income received in advance,

(f) unpaid dividends,

(g) application Money received for allotment of Securities and due for refund and interest accrued thereon (h) unpaid Matured deposits and interest accrued thereon, (i) unpaid Matured debentures and interest accrued thereon, (j) Other Payables (specify nature).
➢ The portion of Long-Term Debts/ Lease Obligations, which is due for payments within 12 months of the reporting date is required to be classified under "Other Current Liabilities", while the balance amount should be classified under long-term Borrowings. ➢ Trade Deposits and Security Deposits which are not in the nature of Borrowings should be classified separately under Other Non-Current/ Current liabilities. ➢ 'Other Payables' under this head may be in the nature of statutory dues such as withholding taxes, Service tax, VAT, Excise duty, etc. ➢ Current/Non-current Classification of Assets / Liabilities is determined on a particular date, i.e., Balance Sheet date. So, if there is any change in the position at the end of the current year resulting in a different classification of Assets / Liabilities in the current year, it will not impact the classification made in the previous year.

(D) SHORT TERM PROVISIONS
It shall be classified as – (a) Provision for Employee Benefits (b) Others (Specifying nature)
➢ This should be classified into short-term and long-term portions, and the former amount should be included here. ➢ "Others" includes Provision for dividend, Provision for taxation, Provision for Warranties, etc.

(1) NON-CURRENT ASSETS

(A) (I) TANGIBLE ASSETS
1. Classification shall be given as – (a) Land, (b) Buildings, (c) Plant and equipment, (d) Furniture & Fixtures, (e) Vehicles, (f) Office Equipment, (g) Others (Specify Nature).
➢ **AS-19** excludes land leases from its scope. Leasehold land should be presented as

a separate assets class under Tangible Assets. Also, Freehold land should be presented as a separate asset class.

- Assets under Lease shall be separately specified under each class of asset. The term "under lease" should mean –
  - Assets given on Operating lease in the case of lessor, and
  - Assets held under Finance lease in the case of lessee.
- Leasehold Improvements should continue to be shown as a separate asset class.
- **AS-10** requires disclosure of details such as Gross Book Value of Revalued Assets, Method adopted to compute revalued amounts, Nature of indices used, year of appraisal, involvement of external valuer, etc. as long as the concerned assets are held by the Enterprise. [But only 5 years period is specified in Sch III. AS-10 requirements will prevail.]
- **AS-26** does not permit revaluation of intangible assets.
- Since reconciliation of Gross and Net Carrying amounts of Fixed assets is required, the depreciation/ Amounts of fixed assets is required, the Depreciation/ amortization for each class of asset should be disclosed in terms of –
  - Opening Accumulated Depreciation,
  - Depreciation/Amortization for the year,
  - Deductions/Other Adjustments, and
  - Closing Accumulated Depreciation/ Amortization
- Similar disclosures should also be made for impairment, if any, as applicable.
- **Business Combinations**: Business Combination should be taken as an amalgamation or acquisition or any other mode of restructuring of a set of assets and/or a group of assets and liabilities constituting a business.
- Acquisitions through 'Business Combinations' should be disclosed separately for each class of assets.
- Asset Disposals through Demergers, etc., if any also be disclosed separately for each class of assets.
- **Other Adjustments**: This includes –
  - Capitalization of FOREX Differences where such option has been exercised by the Company as per **AS-11**.
  - Adjustments on a/c of Exchange Fluctuations for Fixed assets in case of Non-integral Operations (AS11).
  - Borrowing Costs capitalized as per **AS-16**.

(A) (II) INTANGIBLE ASSETS
Classification shall be given as –

(a) Goodwill, (b) Brands / Trademarks, (c) Computer Software, (d) Mastheads and Publishing titles, (e) Mining rights, (f) Copyrights, and Patents and Other intellectual Property rights, Services and Operating rights, (g) recipes, Formula, Models, designs and Prototypes, (h) licenses and Franchise, (i) Others (specify nature).

- Intangible assets under development should also be disclosed separately, if aS-26 criteria are met.

<u>(A) (III) CAPITAL WORK IN PROGRESS</u>

- To be shown as a separate line item on the face of Balance Sheet .
- Capital advances should be included under long term loans and advances and hence, cannot be included under Capital WIP.

<u>(A) (IV) INTANGIBLE ASSETS UNDER DEVELOPMENT</u>

- Intangible assets under development should be disclosed under this head provided they can be recognized based on the criteria laid down in AS-26.

<u>(B) NON CURRENT INVESTMENTS</u>

Non-Current Investments shall be classified as Trade investments and Other investments, and
further classified as Investments in –
(a) Property,
(b) Equity instruments,
(c) Preference Shares,
(d) Government / trust Securities,
(e) Debentures or Bonds,
(f) Mutual Funds,
(g) Partnership Firms, and
(h) Other Non-Current investments (specify nature).

- If a Debenture is to be redeemed partly within 12 months and balance again after 12 months, the amount to be redeemed within 12 months should be disclosed as current, and balance as Non-Current.
- “Trade Investment” is normally understood as an investment made by a Company in Shares or debentures of another Company, to promote the trade or business of the first Company.
- Under each classification, details shall be given about
  - The names of Bodies Corporate (indicating separately whether such bodies are – Subsidiaries, (ii) associates, (iii) Joint Ventures, or (iv) Controlled Special Purpose

entities) in whom investments have been made and

- The nature and
- Extent of the investment so made in each such Body Corporate (showing separately investments which are partly-paid).

➢ "Nature and Extent" of Investment in each Body Corporate should be interpreted to mean the number and face value of Share.

➢ Also, it is advisable to clearly disclose whether investments are fully paid or partly paid. (itemwise)

➢ With regard to investments in the capital of Partnership Firms, the Names of the Firms (with the names of all their Partners, total Capital and the Shares of each Partner) shall be given.

➢ Investments in LLPs will be disclosed separately under "Other Investments".

➢ In case of change in constitution of the Firm during the year, the names of the other partners should be disclosed based on the position existing as on the date of Company's Balance sheet.

➢ Investments carried at other than at Cost should be separately stated specifying the basis for valuation thereof.

➢ Basis could be (a) Cost, or (b) Cost less Provision for other than temporary diminution, or
(c)Lower of Cost and Fair Value.

➢ The following shall also be disclosed- (a) aggregate amount of Quoted investments and Market Value thereof, (b) Aggregate Amount of unquoted investments, (c) aggregate Provision for diminution in value of investments.

(1) (C) DEFERRED TAX ASSET
To be shown as a separate line-item on the face of Balance Sheet.

(1) (D) LONG TERM LOANS AND ADVANCES

1. **General Classification**: Long-term loans and advances shall be classified as –
(a) Capital advances,
(b) Security deposits,
(c) Loans and advances to related Parties (giving details thereof),
(d) Other loans and advances (specify nature)

➢ Capital Advances are advances given for procurement of Fixed assets which are Non-Current Assets. They are not realized back in cash, and over a period, get converted into Fixed assets.

➢ Other loans and Advances should include all other items in the nature of advances recoverable in cash or kind, e.g., Prepaid Expenses, Advance Tax, CENVAT Credit receivable, VAT Credit receivable and Service tax Credit receivable which are not expected to be realized within the next 12 months or operating cycle whichever is longer, from the Balance Sheet date.

2. **Security wise Classification**: the above shall be separately sub-classified as –
(a) Secured, considered Good
(b) Unsecured, considered Good
(c) Doubtful.

3. **Bad / Doubtful**: allowance for Bad and doubtful loans and advances shall be disclosed under the relevant heads separately.

4. **Directors, etc**.: loans and advances due by Directors or Other Officers of the Company or any of
them either severally or jointly with any other persons or amounts due by Firms or Private Companies respectively in which any director is a Partner in a director of a Member should be separately stated.

(1) (E) OTHER NON-CURRENT ASSETS

1. General classification - Other Non-Current Assets shall be classified as
(a) long-term trade receivables (including trade receivables on deferred Credit terms)
(b) Others (specify nature)

- Dues in respect of Insurance Claims, Sale of Fixed assets, Contractually reimbursable expenses, interest accrued on trade receivables, etc., should be classified as "Others" and each such item should be disclosed according to their nature.

2. Security wise Classification:
3. Bad / Doubtful:
4. Directors, etc.:

Same as above.

(2)CURRENT ASSETS

(2) (A) CURRENT INVESTMENTS

Current Investments shall be classified as –
(a) investments in equity instruments,
(b) investment in Preference Shares,
(c) investments in Government or trust Securities,
(d) investments in debentures or Bonds,
(e) investments in Mutual Funds,
(f) investments in Partnership Firms,

(g) Other investments (specify nature)
Principles given for Non-current investments will apply here also to the relevant. However, trade vs Non-Trade Classification, is not required for Current investments.
(2) (B) INVENTORIES
Inventories shall be classified as – (a) Raw materials, (b) Work In Progress, (c) Finished Goods, (d) Stock-in-Trade (in respect of goods acquired for trading), (e) Stores and Spares, (f) Loose tools, (g) Others (specify nature)
➢ Goods in Transit should be included under relevant heads with suitable disclosure. ➢ The heading "Finished Goods" should comprise all Finished Goods other than those acquired for trading purposes. ➢ Those acquired for trading purposes are to be shown under "Stock in Trade".

(2) (C) TRADE RECEIVABLES
1. Aggregate amount of trade receivables outstanding for a period exceeding 6 months from the date they are due for payment should be separately stated.
2. Security wise Details: trade receivables shall be separately sub classified as – (a) Secured, considered Good (b) Unsecured, considered Good (c) Doubtful.
3. Bad /Doubtful: Allowance for Bad and doubtful loans and advances shall be disclosed under the relevant heads separately.
4. Directors, etc: debts due by directors or Other Officers of the Company or any of them either severally or jointly with any other person or debts due by Firms or Private Companies, respectively in which any director is a Partner, or a director, or a Member should be separately stated.
➢ Where no due date is specifically agreed upon, normal credit period allowed by the Company should be taken into consideration for computing the due date, which may vary depending upon the Nature of Goods or Services sold and the type of Customers, etc. ➢ Lean Period Activities: Receivables arising out of sale of materials / rendering of

services during a Company's lean period, should be included under "Trade Receivables", if such activity is in the normal course of business. If they are not part of "normal course of business", they are to be classified under "Other Assets".

(2) (D) CASH AND CASH EQUIVALENTS
Cash and Cash Equivalents shall be classified as – (a) Balances with Banks, (b) Cheques, drafts on Hand, (c) Cash on Hand, (d) Other (Specify nature).
➢ Earmarked Balances with Banks (e.g. for Unpaid dividend) shall be separately stated. ➢ Balances with Banks to the extent held as margin Money or Security against the Borrowings, Guarantees, Other Commitments shall be disclosed separately. ➢ Repatriation restrictions, if any, in respect of Cash and Bank Balances shall be separately stated. ➢ Bank Deposits with more than 12 months Maturity shall be disclosed separately.

(2) (E) SHORT TERM LOANS AND ADVANCES
1. General Classification: Short-Term Loans and Advances shall be classified as – (a) loans and advances to related Parties (giving details thereof), (b) Others (specify nature).
2. Securitywise Classification: The above shall also be subclassified as- (a) Secured, considered Good, (b) unsecured, considered Good, (c) doubtful
3. Bad / doubtful: allowance for Bad and doubtful loans and advances shall be disclosed under the relevant heads separately.
4. Directors, etc.: loans & advances due by directors or Other Officers of the Company or any of them either severally or Jointly with any other person or amounts due by Firms or Private Companies, respectively in which any director is a Partner or a director or a Member shall be separately stated.
(2) (F) OTHER CURRENT ASSETS
➢ This is an all-inclusive heading, which incorporates Current Assets which do not fit into any other Asset Categories.
➢ Nature of each item should be specified. ➢ In case any amount classified under this category is doubtful, it is advisable that such doubtful amount as well as any provision made there against should be separately disclosed. e.g., unbilled revenue, unamortized Premium on Forward Contracts, etc.

<u>Special note :</u> Schedule III does not deal with any accounting treatment of special items (such as Share issue expenses, ancillary borrowing Costs and discount or Premium relating to borrowings), and the same continues to be governed by the respective AS / best practices. So, a Company can disclose the Unamortized Portion of such expenses as "Unamortized Expenses", under the head "Other Current/ Non Current assets", depending on whether the amount will be amortized in the next 12 months or thereafter.

PART II-FORM OF STATEMENT OF PROFIT AND LOSS

Name of the Company :...
Profit and loss Statement for the year ended:.. (rs. in ....)

Sr.No.	Particulars	Note No.	Figures for the Current reporting Period	Figures for the Previous reporting period
I	Revenue from Operations			
II	Other income			
III	Total revenue (I+II)			
IV	Expenses			
	Cost of Materials Consumed Purchases of Stock-In-Trade Changes in inventories of Finished Goods / Work-in-progress and Stock-In-Trade Employee Benefits Expense Finance Costs Depreciation and amortization expense Other expenses			
	Total expenses			
V	Profit before Exceptional & Extraordinary items and tax (III – IV)			
VI	Exceptional items			
VII	Profit before Extraordinary Items and Tax (V-VI)			
VIII	Extraordinary items			

IX	Profit before Tax (VII-VIII)			
X	Tax expenses: (1) Current tax (2) deferred tax			
XI	Profit /(Loss) for the period from Continuing Operations (IX – X)			
XII	Profit /(Loss) from Discontinuing Operations			
XIII	Tax expense of discontinuing Operations			
XIV	Profit /(Loss) from Discontinuing Operations (after tax) (XII-XIII)			
XV	Profit / (Loss) for the period (XI + XIV)			
XVI	earnings per equity Share: (1) Basic (2) Diluted			

DISCLOSURE REQUIREMENTS IN RESPECT OF PROFIT AND LOSS ACCOUNT

1. Section 25 Companies - The provisions of this part shall apply to the income and expenditure account referred to in Sec. 129 of the act, in the same manner as they apply to a Statement of Profit and Loss.
2. Revenue from Operations For Company other than a Finance Company: Revenue from Operations shall disclosed separately in the Notes, revenue from – (a) Sale of Products (b) Sale of Services (c) Other Operating revenues (d) less: excise duty For Finance Company: Revenue from Operations shall include revenue from: (a) interest & (b) Other Financial Services revenue under each of the above heads shall be disclosed separately by way of Notes to accounts to the extent applicable.
3. Finance Costs Finance Costs shall be classified as – (a) Interest expenses, (b) Other Borrowing Costs, (c) Applicable Net Gain / loss on Foreign Currency transactions and translation.

4. Other Income

Other Income shall be classified as –

(a) Interest income (in case of a Company other than a Finance Company),

(b) Dividend income,

(c) Net Gain/loss on Sale of investments,

(d) Other Non-Operating income (Net of expenses directly attributable to such income).

5. Additional Information:

(i) General breakup of income and expense

A Company shall disclose by way of Notes, additional information regarding aggregate expenditure and income on the following items referred below.

a) Employee Benefits Expense [showed separately –
    (i) Salaries & Wages, (ii) Contribution to PF and Other Funds, (iii) Expense on ESOP and Employee Stock Purchase Plan (ESPP), (iv) Staff Welfare expenses.
b) Depreciation and amortization expenses,
c) Any item of income of expenditure which exceeds 1% of revenue from Operations or Rs. 1,00,000 whichever is higher,
d) Interest income,
e) Interest expense,
f) Dividend income,
g) Net Gain / loss on Sale of investments,
h) Adjustments to the Carrying amount of investments,
i) Net Gain / loss on Foreign Currency transaction & translation (other than the cost considered as Finance Cost),
j) Payments to the auditor as – (a) auditor, (b) For taxation Matters, (c) For Company law Matters, (d) For Management Services, (e) For other Services, (f) For reimbursement of expenses,
k) Item of Exceptional and Extraordinary Nature,
l) Prior Period items.

(ii)Materials, goods, Services, etc.

a) In the case of Manufacturing Companies –
- Raw Materials under broad heads.
- Goods Purchased under broad heads.

b) In the case of trading Companies, Purchases in respect of goods traded in by the Company under broad heads.
c) In the case of Companies rendering or supplying services, Gross income derived from Services rendered or Supplied, are shown under broad heads.

d) In the case of Companies rendering or supplying services, Gross income derived from Services rendered or Supplied, are shown under broad heads.
e) Broad heads shall be decided taking into account the concept of materiality and presentation of true and fair view of Financial Statements.

(iii) Reserves - Creation & utilization:

(a) The aggregate, if material, of any amounts set aside or proposed to be set aside to reserve, without including Provisions made to meet any Specific Liability, Contingency or Commitment known to exist at the date as to which the Balance Sheet is made up.

(b) The aggregate, if material, of any amounts withdrawn from such reserves.

(iv) Provision - Creation & utilization:

(a) The aggregate, if material, of the amounts set aside to Provisions made for meeting Specific Liabilities, Contingencies or Commitments.

(b) the aggregate, if material, of the amounts withdrawn from such provisions, as no longer required.

(**v) expenses, etc: expenditure incurred on each of the following items, separately for each item:**

(a) Consumption of Stores and Spare Parts,
(b) Power and Fuel,
(c) Rent,
(d) Repairs of Buildings,
(e) Repairs of Machinery,
(f) Repairs of Machinery,
(g) Insurance,
(h) Rates and taxes, excluding taxes on income,
(i) Miscellaneous expenses.

(vi) Subsidiaries Information:

(a) Dividends from Subsidiary Companies.
(b) Provisions for losses of Subsidiary Companies.

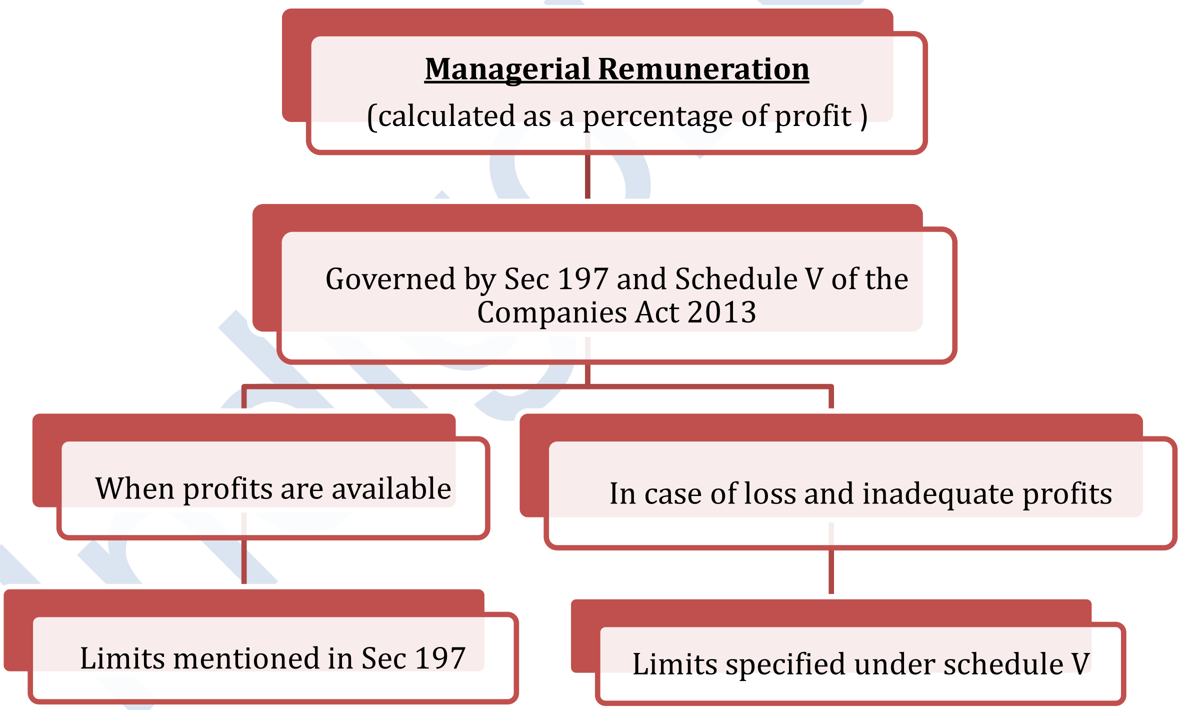
(viii) FOREX Information:

The P&L a/c shall also contain by way of a Note the following information, namely –

(a) Value of imports calculated on CIF basis by the Company during the Financial year in respect of – (i) raw Materials, (ii) Components and Spare Parts, (iii) Capital Goods,

(b) Expenditure in Foreign Currency during the Financial year on account of royalty, Know-how, Professional and Consultation Fees, interest, and Other Matters,
(c) Total Value if all imported raw Materials, Spare Parts and Components consumed during the Financial year and the total Value of all indigenous raw Materials, Spare Parts and Components similarly consumed and the Percentage of each to the total Consumption,
(d) Amount remitted during the year in Foreign Currencies on account of Dividends with a specific mention of the total number of Non-resident Shareholders, the total Number of Shares held by them on which the dividends were due and the year to which the dividends related.
(e) Earnings in Foreign Exchange classified under the following heads, namely-
Export of Goods calculated on FOB Basis, royalty, Know-How, Professional & Consultation Fees, interest and dividend, Other income, indicating the nature thereof

MANAGERIAL REMUNERATION



SECTION 197

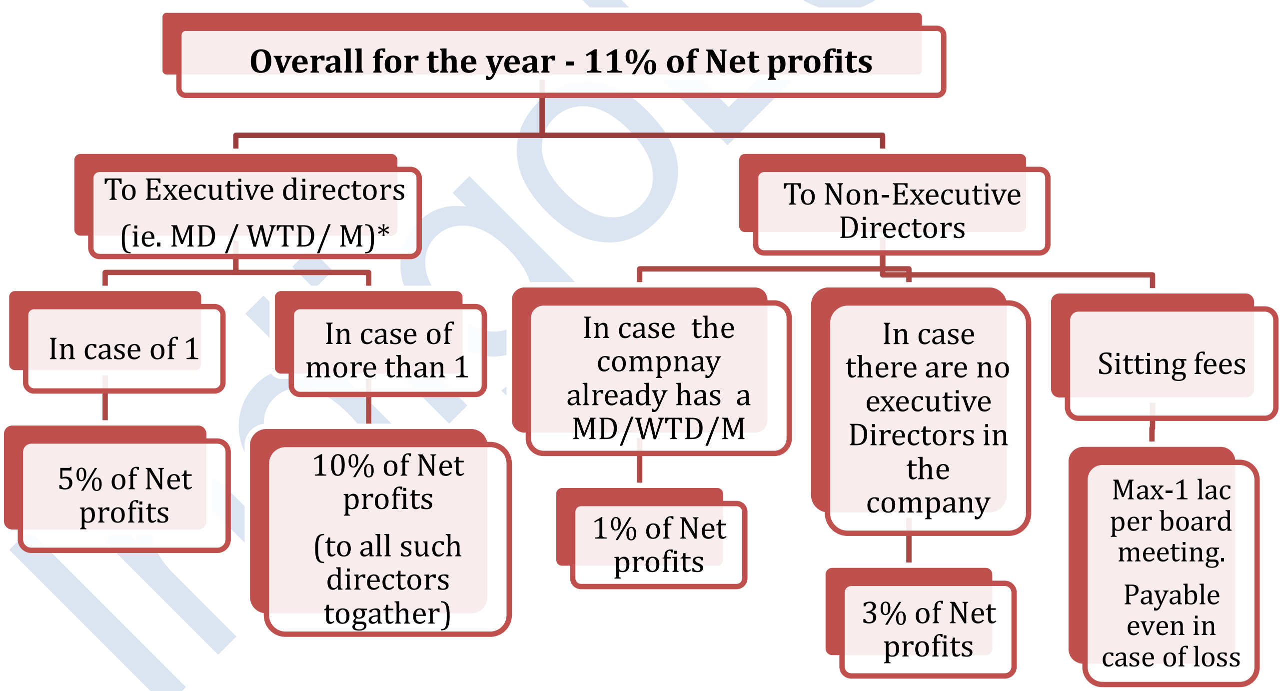
★ Prescribes the overall maximum managerial remuneration payable and also managerial remuneration in case of absence or inadequacy of profits.

★ Total managerial remuneration payable

- by a public company,
- to its directors, including managing director and whole-time director, and its manager
- in respect of any financial year
- should not exceed **11%** of the net profits of that company,
- computed in the manner laid down in section 198
- except that the remuneration of the directors should not be deducted from the gross profits.

★ The company in general meeting may, authorise the payment of remuneration exceeding 11% of the net profits of the company, subject to the provisions of Schedule V.

MAXIMUM MANAGERIAL REMUNERATION -PAYABLE BY A PUBLIC COMPANY IN CASE OF PROFITS



MD / WTD / M = Managing Director/ Whole time director/ Manager

Net profits is computed as specified in Sec 198

SEC 198 - COMPUTATION OF NET PROFIT FOR THE PURPOSE OF COMPUTING MANAGERIAL REMUNERATION

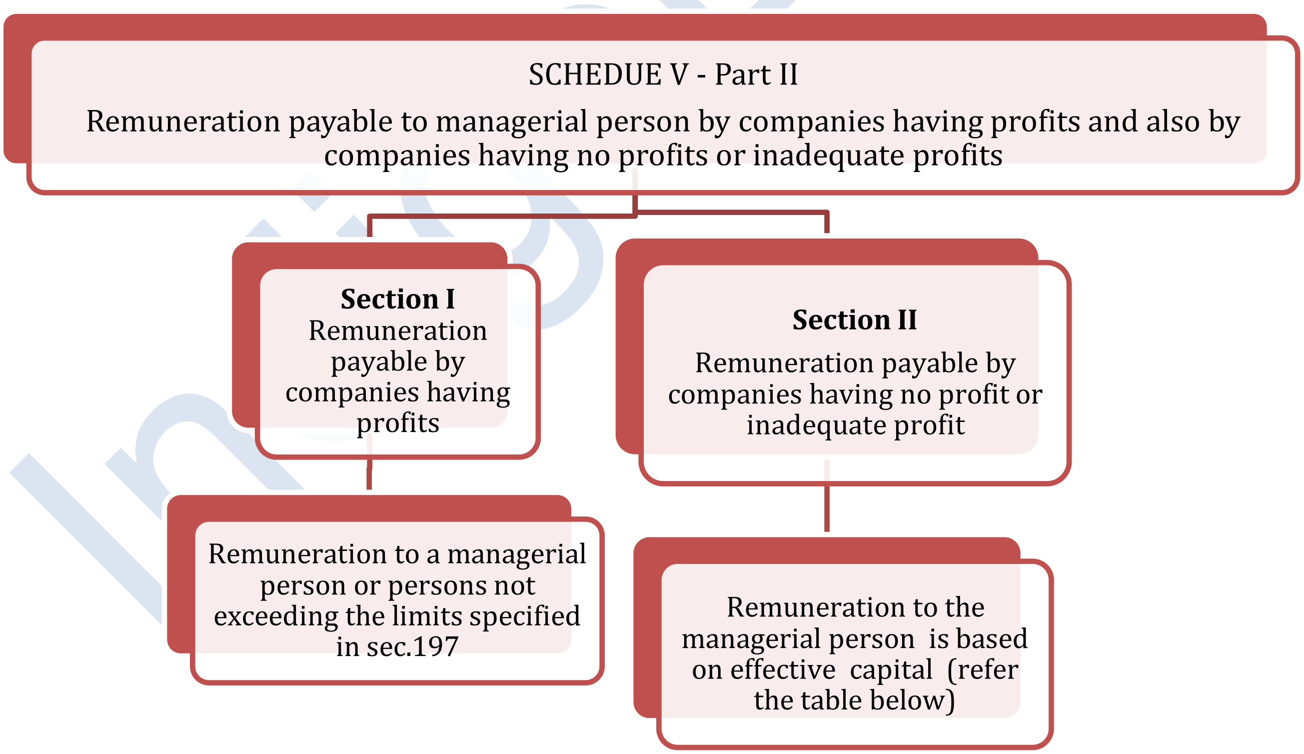
1. THE FOLLOWING CREDIT SHOULD BE ADDED TO GROSS PROFIT
a) Subsidies or bounties received from any Government, or any public authority, unless the Central Government otherwise directs

2. THE FOLLOWING CREDITS SHOULD NOT BE ADDED TO GROSS PROFIT
a) Profits, by way of premium on shares or debentures, which are issued or sold by the company b) Profits on sales by the company of forfeited shares c) Profits of a capital nature including profits from the sale of the undertaking or any of the undertakings of the company or of any part thereof d) Profits from the sale of any immovable property or fixed assets of a capital nature Provided that where the amount for which any fixed asset is sold exceeds the written-down value thereof, credit should be given for so much of the excess as is not higher than the difference between the original cost of that fixed asset and its written- down value. Credit to P&L = [Sale price – WDV]-[Original cost – WDV] e) Any change in carrying amount of an asset or of a liability recognised in equity reserves including surplus in profit and loss account on measurement of the asset or the liability at fair value.

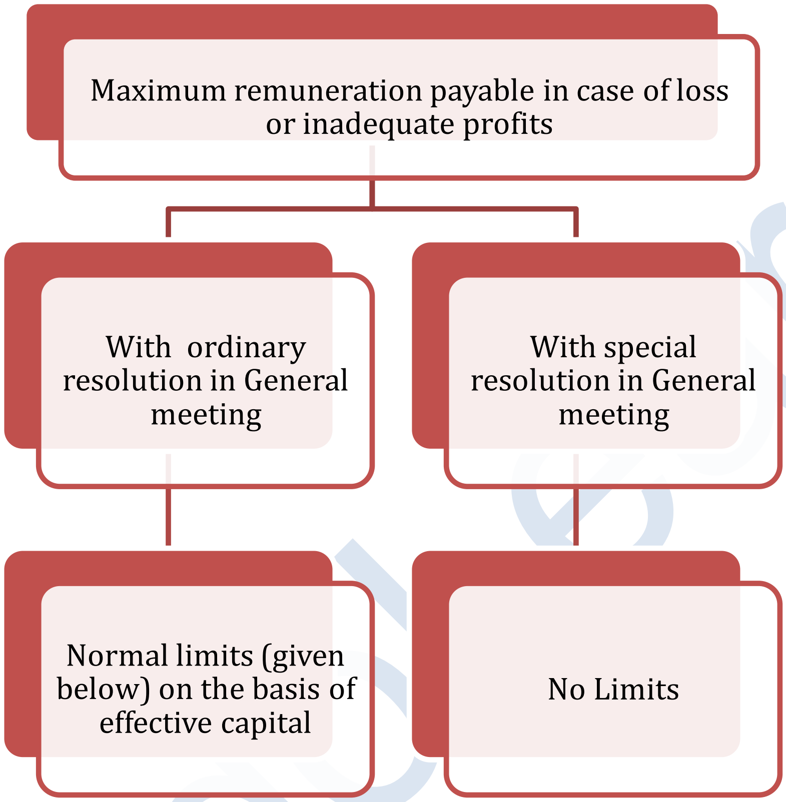
3. THE FOLLOWING DEBITS SHOULD BE DEDUCTED FROM GROSS PROFIT
a) all the usual working charges ~~b) directors' remuneration~~ c) bonus or commission paid or payable d) any tax notified by the Central Government as being in the nature of a tax on excess or abnormal profits e) any tax on business profits imposed for special reasons or in special circumstances and notified by the Central Government in this behalf f) interest on debentures g) interest on mortgages and loans and advances h) interest on unsecured loans and advances i) expenses on repairs, provided the repairs are not of a capital nature j) outgoings inclusive of contributions made under section 181 of the Act k) depreciation to the extent specified in section 123 of the Act l) the excess of expenditure over income, which had arisen in computing the net profits in accordance with this section in any year which begins at or after the commencement of this Act, in so far as such excess has not been deducted in any subsequent year preceding the year in respect of which the net profits have to be ascertained

m) any compensation or damages to be paid in virtue of any legal liability including a liability arising from a breach of contract
n) any sum paid by way of insurance against the risk of meeting any liability such as is referred to in clause (m)
o) bad debts written off

4. THE FOLLOWING DEBITS SHOULD NOT BE DEDUCTED FROM GROSS PROFIT
a) Income-tax and super-tax payable under the Income-tax Act, 1961.
b) Any compensation, damages or payments made voluntarily, (other than those mentioned above)
c) loss of a capital nature not including any excess of the written-down value of any asset which is sold, discarded, demolished or destroyed over its sale proceeds or its scrap value
d) any change in carrying amount of an asset or of a liability recognised in equity reserves including surplus in profit and loss account on measurement of the asset or the liability at fair value



SECTION II - REMUNERATION PAYABLE BY COMPANIES HAVING NO PROFIT OR INADEQUATE PROFIT



NORMAL LIMIT BASED ON EFFECTIVE CAPITAL

Where the effective capital is	Maximum payable per year per director
Negative or less than 5 crores	60 lacs
5 crores and above but less than 100 Crores	84 lacs
100 crores and above but less than 250 Crores	120 lacs
250 crores and above	120 lakhs plus 0.01% of the effective capital in excess of Rs. 250 crores.

EFFECTIVE CAPITAL	
Aggregate of the paid-up share capital (excluding share application money or advances against shares)	xxx
(+) Securities premium account	xxx
(+) Free reserves (excluding revaluation reserve)	xxx
(+) Long- term loans, debentures and deposits repayable after one year (excluding working capital loans, over drafts, interest due on loans unless funded, bank guarantee, etc., and other short- term arrangements)	xxx
Total	**xxx**
(-)aggregate of any investments (except in case of investment by an investment company whose principal business is acquisition of shares, stock, debentures or other securities)	(xxx)
(-)preliminary expenses not written off	(xxx)
(-) accumulated losses	(xxx)
Effective capital	**xxx**

Note -

1. Where the appointment is for a period less than 1 year then limits should be pro-rated.
2. Where the appointment of the managerial person is made in the year in which company has been incorporated, the effective capital should be calculated as on the date of such appointment
3. In any other case the effective capital should be calculated as on the last date of the financial year preceding the financial year in which the appointment of the managerial person is made.
4. For the purposes of this Schedule, "negative effective capital" means the effective capital which is calculated in accordance with the provisions contained above is less than zero

CONDITIONS SUBJECT TO WHICH THE LIMITS APPLY

★ Payment of remuneration is approved by a Board resolution passed and, in the case of a company covered under Section 178(1) also by the Nomination and Remuneration Committee.

★ The company has not committed any default in repayment of any of its debts (including public deposits) or debentures or interest payable thereon for a continuous period of 30 days in the preceding financial year before the date of appointment of such managerial person and

- ★ In case of a default, the company obtains prior approval from secured creditors for the proposed remuneration and the fact of such prior approval having been obtained is mentioned in the explanatory statement to the notice convening the general meeting
- ★ An ordinary resolution or a special resolution, as the case may be, has been passed at the general meeting of the company for a period not exceeding 3 years.
- ★ A statement along with a notice calling the general meeting referred to in the above clause is given to the shareholders containing the following information, namely:-

I. **General Information**:

(1) Nature of industry
(2) Date or expected date of commencement of commercial production.
(3) In case of new companies, expected date of commencement of activities as per project approved by financial institutions appearing in the prospectus
(4) Financial performance based on given indicators
(5) Foreign investments or collaborations, if any.

II. **Information about the appointee:**

(1) Background details
(2) Past remuneration
(3) Recognition or awards
(4) Job profile and his suitability
(5) Remuneration proposed
(6) Comparative remuneration profile with respect to industry, size of the company, profile of the position and person (in case of expatriates the relevant details would be with respect to the country of his origin)
(7) Pecuniary relationship directly or indirectly with the company, or relationship with the managerial personnel, if any.

III. **Other information**:

(1) Reasons of loss or inadequate profits
(2) Steps taken or proposed to be taken for improvement
(3) Expected increase in productivity and profits in measurable terms.

IV. **Disclosures:**

The following disclosures should be mentioned in the Board of Director's report under the heading "Corporate Governance", if any, attached to the financial statement:-

(1) all elements of remuneration package such as salary, benefits, bonuses, stock options, pension, etc., of all the directors;
(2) details of fixed component and performance linked incentives along with the

performance criteria;

(3) service contracts, notice period, severance fees;

(4) stock option details, if any, and whether the same has been issued at a discount as well as the period over which accrued and over which exercisable.

PERQUISITES NOT INCLUDED IN MANAGERIAL REMUNERATION

1. A managerial person should be eligible for the following perquisites which should not be included in the computation of the ceiling on remuneration specified in Section II and Section III:-
   - (a) contribution to provident fund, superannuation fund or annuity fund to the extent these either singly or put together are not taxable under the Income-tax Act, 1961;
   - (b) gratuity payable at a rate not exceeding half a month's salary for each completed year of service; and
   - (c) encashment of leave at the end of the tenure.
2. In addition to the perquisites specified in paragraph 1 of this section, an expatriate managerial person (including a non-resident Indian) should be eligible to the following perquisites which should not be included in the computation of the ceiling on remuneration specified in Section II or Section III-
   - (a) Children's education allowance: In case of children studying in or outside India, an allowance limited to a maximum of Rs. 12,000 per month per child or actual expenses incurred, whichever is less. Such allowance is admissible up to a maximum of two children.
   - (b) Holiday passage for children studying outside India or family* staying abroad: Return holiday passage once in a year by economy class or once in two years by first class to children and to the members 'of the family* from the place oftheir study or stay abroad to India if they are not residing in India, with the managerial person.
   - (c) Leave travel concession: Return passage for self and family in accordance with the rules specified by the company where it is proposed that the leave be spent in home country instead of anywhere in India.

*For the purposes of this Schedule, "family" means the spouse, dependent children and dependent parents of the managerial person

DIVISIBLE PROFIT

- ★ A dividend is a distribution of divisible profit of a company among the members according to the number of shares held by each of them in the capital of the company and the rights attaching thereto.
- ★ Such a distribution may or may not entail a release of assets; it would be where a distribution involves payment of cash.d
- ★ Bonus shares cannot be issued in lieu of dividends.
- ★ Capital cannot be returned to the shareholders by way of dividend.
- ★ A company who has committed any default in compliance with the provisions of sec-73 and 74 relating to the acceptance and repayment of deposits would be barred to declare dividend.
- ★ Dividend should be declared or paid only from free reserves.
- ★ Dividend shall be payable by way of

  (i) cash (ii) cheque (iii) warrant or (iv) in any electronic mode
- ★ It shall be payable to the registered shareholder of such share or to his order or to his banker
- ★ A company **may,** before the declaration of any dividend in any financial year, transfer such percentage of its profits for that financial year, as it may consider appropriate to the reserves of the company.

  Appropriation of a part of profit can be done in the following cases

  1. When required under a law - For example, under the Banking Regulation Act

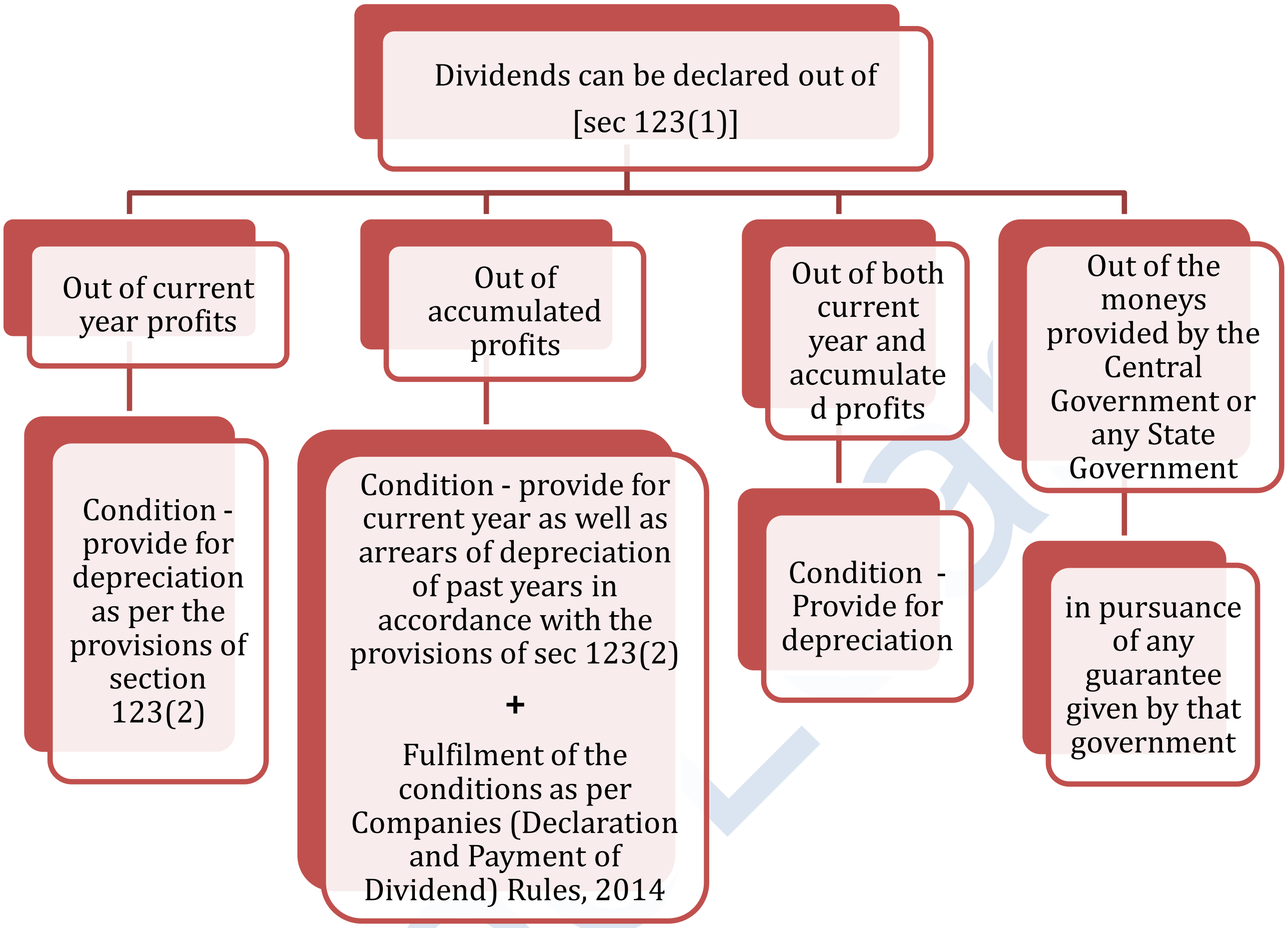
  2. When required under any contract – For example where the company has undertaken, at the time of raising of loan, that before any part of its profit is distributed, a specified percentage of the profit every year should be credited to a reserve for the repayment of the loan and until the time for repayment arrives, the amount should remain invested in a specified manner
- ★ A company may if so authorised by its Article, pay a dividend in proportion to the amount paid on each share in case of partly paid shares.
- ★ Calls paid in advance do not rank for payment of dividend.
- ★ Dividend on preference shares
  - ➢ Holders of preference shares are entitled to receive a dividend at a fixed rate before any dividend is declared on equity shares.
  - ➢ But such a right can be exercised subject to there being profits and the Directors

recommending payment of the dividend.

★ As per Section 2 (35) of the Companies Act, 2013, term "Dividend" includes interim dividend also.

Final dividend	**Interim dividend**
Declared at the AGM	Declared between 2 AGMs
Paid after the finalization of accounts of the year	Paid before the finalization of accounts.
Dividend is recommended by BOD but approved by shareholders in AGM. (share holders can reduce the rate of dividend but they cannot increase it)	This dividend is declared by BOD.
Once it is declared it becomes the liability of the company and it must pay the amount.	This can be revoked with the consent of the shareholders

★ **Sec 123 (3)** - In case the company has incurred loss during the current financial year up to the end of the quarter immediately preceding the date of declaration of interim dividend, such interim dividend should not be declared at a rate higher than the average dividends declared by the company during the immediately preceding three financial years.



★ <u>Sec 123(2)</u> - Depreciation must be to the extent specified in Schedule II to the Companies Act, 2013.

➢ When the assets are sold, discarded, demolished or destroyed in any financial year, the excess of the written down value over its sale proceeds as scrap, if any should be written off in the same financial year.

★ **<u>Conditions as per Companies (Declaration and Payment of Dividend) Rules, 2014</u>**

(1) The **<u>rate of dividend</u>** declared should not exceed the average of the rates at which dividend was declared by it in the three years immediately preceding that year: However this condition shall not apply to a company, which has not declared any dividend in each of the three preceding financial year.

(2) The **<u>total amount to be drawn</u>** from such accumulated profits should not exceed one-tenth of the sum of its paid-up share capital and free reserves as appearing in the latest audited financial statement.

(3) The **<u>amount so drawn should first be utilised</u>** to set off the losses incurred in the financial year in which dividend is declared before any dividend in respect of equity shares is declared.

(4) The **balance of reserves** after such withdrawal should not fall below 15% of its paid up share capital as appearing in the latest audited financial statement.

(5) No company should declare dividend unless **carried over previous losses** and depreciation not provided in previous year, are set off against profit of the company of the current year. The loss or depreciation, whichever is less, in previous years is set off against the profit of the company for the year for which dividend is declared or paid.

★ **Sec 124 - Payment of dividend**

(1) **Deposit in separate bank** - The amount of the dividend, including interim dividend, should be deposited in a scheduled bank in a separate account **within 5 days** from the date of declaration of such dividend.

(2) **Mandatory payment** - The dividend declared should be **paid** to the share holder **within 30 days** from the date of declaration.

(3) **Transfer to unpaid dividend account** - Where any dividend has not been paid or claimed within thirty days from the date of the declaration to any shareholder the company should, **within 7 days** from the date of expiry of the said period of 30 days, transfer the total amount of dividend which remains unpaid or unclaimed to a special account to be opened by the company in that behalf in any scheduled bank to be called the Unpaid Dividend Account.

(4) **Statement to be placed on website** - The company should, **within a period of 90 days** of making any transfer to the Unpaid Dividend Account, prepare a statement containing the names, their last known addresses and the unpaid dividend to be paid to each person and place it on the website of the company, if any, and also on any other website approved by the Central Government for this purpose, in such form, manner and other particulars as may be prescribed.

(5) **Interest of 12% in case of default -** If any default is made in transferring any amount to the Unpaid Dividend Account, the company should pay, from the date of such default, interest on such amount, at the rate of 12% per annum.

(6) **Claim to company -** Any person claiming to be entitled to any money transferred to the Unpaid Dividend Account of the company may apply to the company for payment of the money claimed.

(7) **Transfer to Investor education and protection fund** - Any money transferred to the Unpaid Dividend Account of a company which remains **unpaid or unclaimed for a period of 7 years** from the date of such transfer should be transferred by the company along with interest accrued, if any, thereon to the Fund "Investor Education and Protection Fund" established section 125.

(8) **Statement of such transfer -** The company should send a statement in the prescribed form of the details of such transfer to the authority which administers the said Fund and that authority should issue a receipt to the company as evidence of such transfer.

(9) **Transfer of Share -** All shares in respect of which unpaid or unclaimed dividend has been transferred to "Investor Education and Protection Fund" should also be transferred by the company in the name of Investor Education and Protection Fund along with a statement containing such details as may be prescribed:
Provided that any claimant of shares transferred above should be entitled to claim the transfer of shares from Investor Education and Protection Fund in accordance with such procedure and on submission of such documents as may be prescribed.

(10) **Punishment for failure to distribute dividend** - If a company fails to comply with any of the requirements of this section,

Liability for	**Fine**
Company	not be less than 5,00,000 but which may extend to Rs.25,00,000
Every officer of the company who is in default	not be less than Rs.1,00,000 but which may extend to Rs.5,00,000.

ACCOUNTING FOR TAXES

★ AS 22 Accounting for Taxes on Income prescribes the accounting treatment of taxes on income and follows the concept of matching expenses against revenue for the period.

★ The concept of matching is more peculiar in cases of income taxes since in a number of cases, the taxable income may be significantly different from the income reported in the financial statements due to the difference in treatment of certain items under taxation laws and the way it is reflected in accounts.

★ Accounting for taxes on income should be in accordance with AS 22, irrespective of whether such taxes are imposed by an Indian law or by the law of a foreign country.

★ The amount to be included in respect of income-tax in the profit and loss account should be the current tax plus or minus the deferred tax. Current tax is the tax determined in accordance with the provisions of the Income- tax Act, 1961. Deferred tax is the tax effect of timing differences.

Difference between accounting and income and the taxable income

Permanent differences

1.These differences which originate in one period and do not reverse subsequently.

2.They arise due to recognition of revenues/gains/expenses/loses in the profit and loss account but not for income-tax computation or vice versa.

3.No accounting adjustments are necessary for tax effects of permanent differences.

Timing differences

1.These differences originate in one period and are capable of reversal in one or more subsequent periods. (Although, 100% certainty of reversal is not there)

2.They arise only in respect of incomes/expenses which are considered both in the profit and loss account as well as for computation of taxable income, although, in different periods.

3.It may result in a deferred tax asset or a deferred tax liability.

The tax effect of timing difference i.e. deferred tax should be treated in the following manner:

The deferred tax should form part of the tax expenses in the profit and loss account; and

It should be accounted as a deferred tax asset (DTA)/deferred tax liability (DTL) in the balance sheet.

DTA or DTL is created in the following cases

When book profit > taxable profit	Deferred tax liability is created
When book profit < taxable profit	Deferred tax asset is created

DTA is recognized in a case where there are unabsorbed losses/deprecation under the tax laws.

DTA should be recognized only to the extent there is virtual certainty supported by convincing evidence that adequate future taxable income will be available against which DTAs can be realised. Mere forecasts of performance would not satisfy this criterion.

virtual certainty has to be backed up by convincing evidence i.e. evidence available at the reporting date in concrete form.

Journal entries	
In the year in which timing difference originates – In case of DTA	
DTA A/c	Dr.
To Profit & loss A/c	
Note : The amount to be debited and credited arrived at by multiplying the timing difference with the tax rate applicable for the year	
In case of DTL	
Profit and Loss A/c	Dr.
To Deferred tax Liability A/c	
In the subsequent year - This is the entry to be passed to account for the difference between the opening and closing balance in the DTA a/c which represents reversal of timing difference during the year	
Profit and loss A/c	Dr.
To DTA A/c	
Note:	
1. The carrying amount of DTAs has to be reviewed at each balance sheet date.	
2. The carrying amount of a DTA has to be written down to the extent that it is no longer reasonably certain or virtually certain, as the case may be, that adequate future taxable income would be available to realize the DTA.	
3. Reversal of a previous write-down may be done to the extent it becomes reasonably certain or virtually certain, as the case may be, that adequate future taxable income would be available.	
4. If the recognition criteria is not met, the entire balance should be written off.	

Illustrations – Framework

Illustration - 1

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

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

Additional information:
(a) The remaining life of fixed assets is 5 years. The pattern of use of the asset is even. The net realisable value of fixed assets 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 for the year amounted to Rs. 14,900.
(e) Deferred cost is amortised equally over 4 years.
(f) Debtors 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 the Profit and Loss Accounts and Balance Sheets of the trader in two cases
- (i) assuming going concern
- (ii) not assuming going concern.

Illustration 2
Suppose at the beginning of an accounting period, aggregate values of assets and liabilities of a trader are Rs. 5 lakhs and Rs. 2 lakhs respectively.

The trader during the year had the following transactions:

(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.

(d) Wages paid Rs.2,000

(e) Rent outstanding Rs.1,000

(f) Drawings of Rs.4,000

Illustration 3

- Purchase of machinery @ Rs. 5,00,000
- Book value (historical cost) = Rs. 4,00,000
- Realisable value (today) = Rs.3,00,000
- Future economic benefits (net cash) = Rs. 1,00,000 for each of the next 5 years

Illustrations – Preparation of Financial Statements

Illustration 1

The following is the Trial Balance of Omega Limited as on 31.3.20X2:

(Figures in Rs.'000)

Particulars	Debit Rs.	Particulars	Credit Rs.
Land at cost	220	Equity Capital (Shares of Rs. 10 each)	300
Plant & Machinery at cost	770	10% Debentures	200
Trade Receivables	96	General Reserve	130
Inventories (31.3.X2)	86	Profit & Loss A/c	72
Bank	20	Securities Premium	40
Adjusted Purchases	320	Sales	700
Factory Expenses	60	Trade Payables	52
Administration Expenses	30	Provision for Depreciation	172
Selling Expenses	30	Suspense Account	4
Debenture Interest	20		
Interim Dividend Paid	18		
	1670		**1670**

Additional Information:

i. The authorised share capital of the company is 40,000 shares of Rs. 10 each.
ii. The company on the advice of independent valuer wish to revalue the land at Rs. 3,60,000.
iii. Declared final dividend @ 10%.
iv. Suspense account of Rs. 4,000 represents cash received for the sale of some of the machinery on 1.4.20X1. The cost of the machinery was Rs. 10,000 and the accumulated depreciation thereon being Rs. 8,000.
v. Depreciation is to be provided on plant and machinery at 10% on cost.

You are required to prepare Omega Limited's Balance Sheet as on 31.3.20X2 and Statement of Profit and Loss with notes to accounts for the year ended 31.3.20X2 as per Schedule III. Ignore previous years' figures & taxation.

Illustration – 2

You are required to prepare a Profit and Loss Account and Balance Sheet from the following Trial Balance extracted from the books of the international Hotels Ltd., on 31st March, 20X2.

Particulars	Debit	Credit
Authorized Capital - divided into 5,000 6% Preference Shares of Rs.100 each and 10,000 equity shares of Rs.100 each		15,00,000
Subscribed Capital –		
5,000 6% Preference Shares of Rs.100 each		5,00,000
Equity Capital		8,05,000
Purchases – Wines, Cigarettes, Cigars etc	45,800	
- Foodstuffs	36,200	
Wages and Salaries	28,300	
Rent, Rates and Taxes	8,900	
Laundry	750	
Sales – Wines, Cigarettes, Cigars, etc.		68,400
- Food		57,600
Coal and Firewood	3,290	
Carriage and Cooliage	810	
Sundry Expenses	5,840	
Advertising	8,360	
Repairs	4,250	
Rent of Rooms		48,000
Billiard		5,700
Miscellaneous Receipts		2,800
Discount received		3,300
Transfer fees		700
Freehold Land and Building	8,50,000	
Furniture and Fittings	86,300	
Stock on hand, 1st April, 2011:		
Wines, Cigarettes, Cigars etc.	12,800	
Foodstuffs	5,260	
Cash in hand	2,200	
Cash with Bankers	76,380	
Preliminary and formation expenses	8,000	
2,000 Debentures of Rs.100 each (6%)		2,00,000
Profit and Loss Account		41,500
Sundry Creditors		42,000
Sundry Debtors	19,260	
Investments	2,72,300	
Goodwill at cost	5,00,000	
General Reserve		2,00,000

	19,75,000	**19,75,000**
Wages and Salaries Outstanding	1,280	
Stock on 31st March, 2012:		
Wines Cigarettes and Cigars, etc.	22,500	
Foodstuffs	16,400	

- Depreciation : Furniture and Fittings @ 5% p.a.: Land & Buildings @ 2% p.a.
- The equity capital on 1st April 2011 stood at Rs.7,20,000 that is 6,000 shares fully paid and 2,000 shares Rs.60 paid.
- The directors made a call of Rs.40 per share on 1st October 20X1. A shareholder could not pay the call on 100 shares and his shares were then forfeited and reissued @ Rs.90 per share as fully paid.
- The directors propose a dividend of 8% on equity shares, transferring any amount that may be required from General Reserve.
- Ignore Taxation

Illustration - 3

From the following particulars furnished by Pioneer Ltd., prepare the Balance Sheet as at 31st March, 20X1 as required by Schedule III of the Companies Act. Give notes at the foot of the Balance Sheet as may be found necessary –

	Rs.	Assets (Rs.)	Liabilities (Rs.)
Equity Capital (Face value of Rs.100) Calls in Arrears		1,000	10,00,000
Land		2,00,000	
Building		3,50,000	
Plant and Machinery		5,25,000	
Furniture		50,000	
General Reserve			2,10,000
Loan from State Financial Corporation			1,50,000
Inventory:			
Finished Goods	2,00,000		
Raw Materials	50,000	2,50,000	
Provision for Taxation			68,000
Trade receivables		2,00,000	
Advances		42,700	

Dividend Payable			60,000
Profit and Loss Account			86,700
Cash Balance		30,000	
Cash at Bank		2,47,000	
Loans (Unsecured)			1,21,000
Trade payables (For Goods and Expenses)			2,00,000
		18,95,700	18,95,700

The following additional information is also provided:

- 2,000 equity shares were issued for consideration other than cash.
- Trade receivables of Rs.52,000 are due for more than six months.
- The cost of assets:

Building	Rs.4,00,000
Plant and Machinery	Rs.7,00,000
Furniture	Rs.62,500

- The balance of Rs.1,50,000 in the loan account with State Finance Corporation is inclusive of Rs.7,500 for interest accrued but not due. The loan is secured by hypothecation of the Plant and Machinery.
- Balance at Bank includes Rs.2,000 with Perfect Bank Ltd., which is not a Scheduled Bank.
- The company had contract for the erection of machinery at Rs.1,50,000 which is still incomplete.

Illustration - 4

Due to inadequacy of profits during the year ended 31st March, 20X2, XYZ Ltd. proposes to declare 10% dividend out of general reserves. From the following particulars, ascertain the amount that can be utilised from general reserves, according to the Companies (Declaration of dividend out of Reserves) Rules, 2014:

	(Rs.)
17,500 9% Preference shares of Rs. 100 each, fully paid up	17,50,000
8,00,000 Equity shares of Rs. 10 each, fully paid up	80,00,000
General Reserves as on 1.4.20X1	25,00,000
Capital Reserves as on 1.4.20X1	3,00,000
Revaluation Reserves as on 1.4.20X1	3,50,000
Net profit for the year ended 31st March, 20X2	3,00,000

Average rate of dividend during the last five year has been 12%.

Illustration 5

The following extract of Balance Sheet of X Ltd. was obtained:

Balance Sheet **(Extract)** as on 31st March, 20X1

Liabilities	Rs.
Authorised capital: 20,000, 14% preference shares of Rs.100	20,00,000
2,00,000 Equity shares of Rs.100 each	2,00,00,000
Issued and subscribed capital:	2,20,00,000
15,000, 14% preference shares of Rs.100 each fully paid	15,00,000
1,20,000 Equity shares of Rs.100 each, Rs.80 paid-up	96,00,000
Share suspense account	20,00,000
Reserves and surplus: Capital reserves (Rs. 1,50,000 is revaluation reserve)	1,95,000
Securities premium	50,000
Secured loans: 15% Debentures	65,00,000
Unsecured loans: Public deposits	3,70,000
Cash credit loan from SBI (short term)	4,65,000
Current Liabilities: Trade Payables	3,45,000
Assets:	**Rs.**
Investment in shares, debentures, etc.	75,00,000
Profit and Loss account (Debit balance)	15,25,000

Share suspense account represents application money received on shares, the allotment of which is not yet made.
You are required to compute effective capital as per the provisions of Schedule V.
Would your answer differ if X Ltd. is an investment company?

Illustration – 6

The following is the Draft Profit & Loss A/c of Mudra Ltd., the year ended 31st March, 20X1:

	Rs.		**Rs.**
To Administrative, Selling and distribution expenses	8,22,542	By Balance b/d	5,72,350

To Directors fees	1,34,780	By Balance from Trading A/c	40,25,365
To Interest on debentures	31,240	By Subsidies received from Govt.	2,73,925
To Managerial Remuneration	2,85,350		
To Depreciation on fixed Assets	522,543		
To Provision for Tax	12,42,500		
To General Reserve	4,00,000		
To Investment Revaluation Reserve	12,500		
To Balance c/d	14,20,185		
	48,71,640		**48,71,640**

Depreciation on fixed assets as per Schedule II of the Companies Act, 2013 was Rs.5,75,345. You are required to calculate the maximum limits of the managerial remuneration as per the Companies Act, 2013.

Illustration 7

Kumar Ltd., a non-investment company has been incurring losses for the past few years. The company provides the following information for the current year:

	(Rs. In lakhs)
Paid up equity share capital	120
Paid up Preference share capital	20
Reserves (including Revaluation reserve Rs.10 lakhs)	150
Securities premium	40
Long term loans	40
Deposits repayable after one year	20
Application money pending allotment	720
Accumulated losses not written off	20
Investments	180

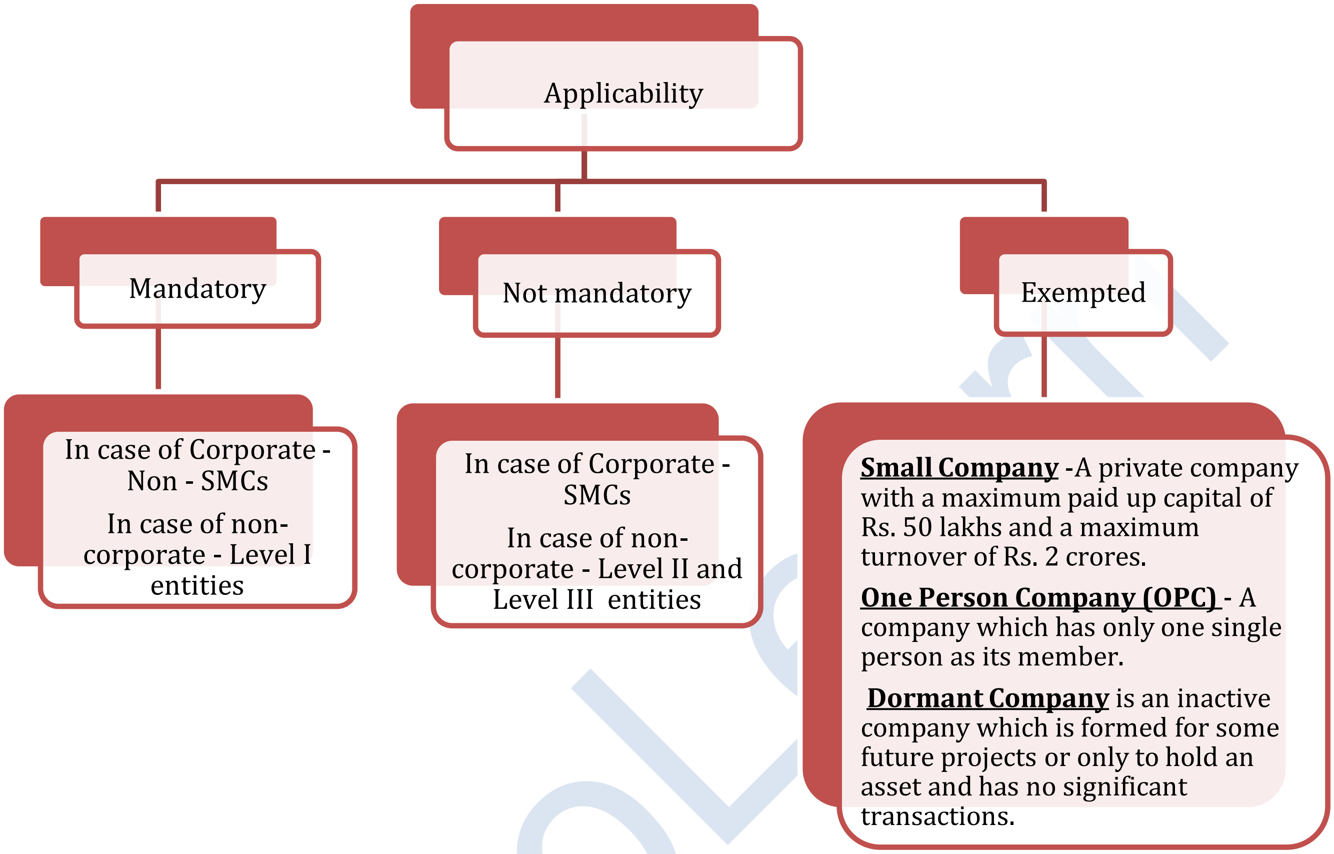
Kumar Ltd. has only one whole-time director, Mr. X. You are required to calculate the amount of maximum remuneration that can be paid to him as per provisions of Part II of Schedule XIII, if no special resolution is passed at the general meeting of the company in respect of payment of remuneration for a period not exceeding three years.

CASH FLOW STATEMENT

INTRODUCTION

- ★ 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 utilized (outflow of cash) by the enterprise.
- ★ Any transaction, which ***does not result in cash flow***, should not be reported.
  E.g.: Conversion of Debt into Equity, Depreciation charges, Acquisition of asset by issuing shares. Etc.
- ★ ***Movements within*** cash or cash equivalents are not cash flows.
- ★ A break-up of opening and closing cash shown as a note to cash flow statement.
- ★ ***Fundamental technique*** of cash flow preparation – It is difficult to compile a summary of cash transactions from cashbooks due to the large volume of transactions. Thus, it is possible to compile such a summary by comparing financial statements at the beginning and at the end of accounting period.

APPLICABILITY



TRANSITION PROVISION

For all other enterprises though it is not compulsory, but it is encouraged to prepare such statements.

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 enterprise 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.

Transition Provision

Previous Year – Exempted
Current Year – Mandatory
Mandate – Not required to show corresponding Previous Year figures

Previous Year – Exempted
Current Year – Mandatory
Mandate – Continue to prepare Cash Flow Statement for next two consecutive years

OBJECTIVE

- To identify the ***historical changes*** in the flow of cash & cash equivalents.
- To determine the ***future requirement*** of cash & cash equivalents.
- 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.

BENEFITS

- Identifies cash generated from trading operations.
- The operating cash surplus which can be applied for investment in fixed assets.
- Portion of cash from operations is used to pay dividend and tax and the other portion is ploughed back.
- Very useful tool of planning

CASH AND CASH EQUIVALENTS

Cash in Hand and at bank

Demand deposits with banks and Financial Institutions

Short term investments - highly liquid– Subject to insignificant risk of change in value.

Eg: T-bills, Commercial papers, marketable securities

Securities with short maturity period – Maturity within 3 months

TYPES OF CASH FLOW

Classification of cash flow activities

Operating cash flows

Generated by Operating activities. ie. the principal revenue-producing activities .

Eg. cash purchase and sale of goods, collections from customers ,payment to suppliers, payment of salaries, wages etc.

Investing cash flows

Generated by Investing activities. ie. Acquisition and disposal of long-term assets and other investments not included in cash equivalents.

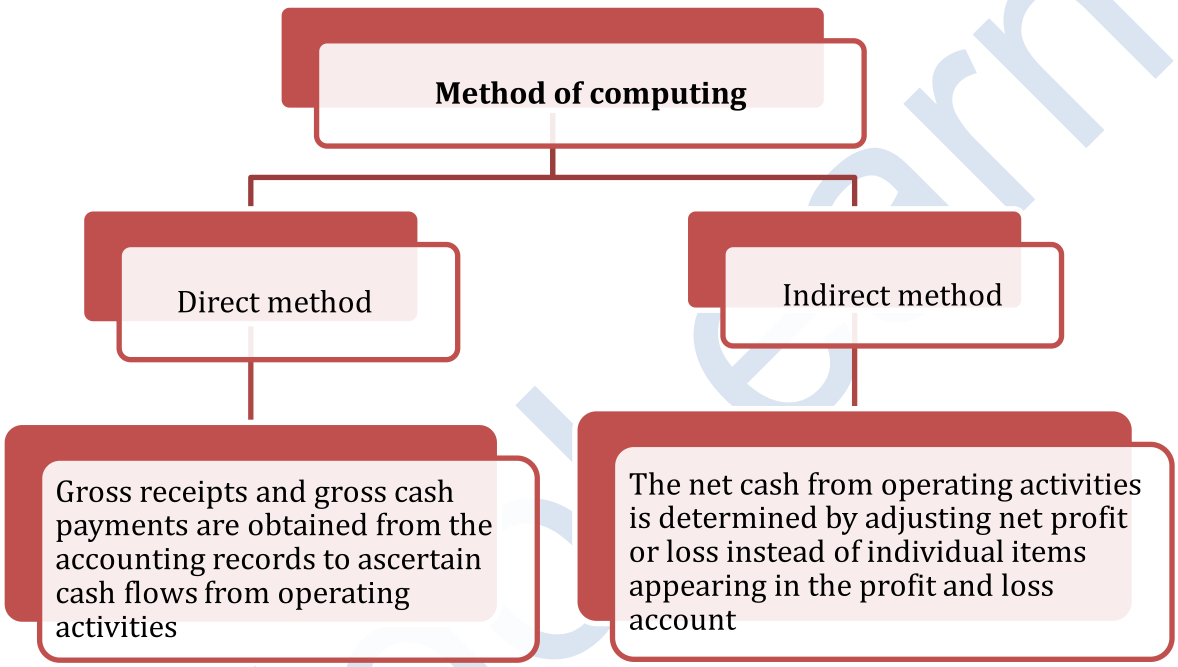
Eg. Receipts from disposals of fixed assets; loan given to / recovered from other entities etc.

Financing cash flows

Generated by financing activities. ie. activities that result in changes in the size and composition of the owners' capital and borrowings of the enterprise. Eg. Issue of shares / debentures, redemption of debentures / preference shares etc.

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.

METHOD OF ACCOUNTING



1. The direct method provides information which may be useful in estimating future cash flows and which is not available under the indirect method and is, therefore, considered more appropriate than the indirect method.
2. Direct method adjusts individual items of profit and loss account and indirect method adjusts overall net profit (or loss) to determine cash from operation.
3. However, indirect method of determining the cash from operating activities is more popular in actual practice.
4. Cash flow from Financing activities and Investing activities are computed in the same manner under both the methods.

Format for Cash Flow from Operating activities under Direct method

Particulars	**Amount**	**Amount**
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 e.g. power, rent,	xxx	
electricity Payment for	xxx	
wages & salaries Payment	xxx	
for Income Tax		(xxx)
		xxx
Adjustment for Extraordinary Items		xxx
Net Cash Flow from Operating Activities		Xxx

Format for Cash Flow from Operating activities under Indirect method

Particulars	Amount	Amount
Net Profit for the year		xxx
Add: Non-Cash and Non-Operating Expenses:	xxx	
Depreciation	xxx	
Loss on Sale of Assets	xxx	
Provision for taxation, etc.	xxx	
Less: Non-Cash and Non-Operating Incomes:		
Profit on Sale of Assets	xxx	
Net Profit after Adjustment for Non-Cash Items		(xxx)
Cash from operation		
Net Profit (after adjustment for Non-cash Items)	xxx	
(-) Increase in Current Assets	xxx	
(-) Decrease in Current Liability	xxx	
(+) Decrease in Current Asset	xxx	
(+) Increase in Current Liabilities	xxx	
Cash flow from Operating activities		Xxx

CLASSIFICATION OF BUSINESS ACTIVITIES

OPERATING ACTIVITIES

Cash inflows:

1.Cash sales

2.Cash from fees, commission and other income

3.Cash received from debtors

Cash outflow:

1. Cash purchases

2.Cash paid for operating expenses like salaries, rent etc

3. Cash paid to creditors

4. Payment of Income tax

INVESTING ACTIVITIES

Cash inflows:

1. Proceeds from sale of fixed assets

2. Proceeds from sale of non-current assets

3. Interest received on debentures

4. Dividend received on shares

Cash outflow:

1. Purchase of fixed assets

2. Purchase of non-current assets

FINANCING ACTIVITIES

Cash inflows:

1. Proceeds from issue of shares / debentures

2. Loan raised (both long term and short term)

3.Increase in bank overdraft or cash credit

Cash outflow:

1.Payment for buy back of equity shares

2.Redemption of Preference shares/Debentures

3.Repayment of loans

4.Payment of dividend

5. Payment of Interest on loans

6. Payment of preliminary expenses

7. Decrease in bank overdraft or cash credit

Note: 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**.

Format for Cash Flow statement under Indirect method

Particulars	Amount	Amount
A. Cash flow from operating activities		
Net Profit for the year	xxx	xxx
Add: Non-Cash and Non-Operating Expenses:	xxx	
Less: Non-Cash and Non-Operating Incomes:	xxx	
Operating profit before working capital changes		xxx
Add: Decrease in current assets & Increase in current liabilities	xxx	
Less: Increase in current assets & Decrease in current liabilities	xxx	
Cash generated from operations		xxx
Less: Income tax paid (net of tax refund received)		(xx)
Net cash from operating activities		xxx
B. Cash flows from Investing activities		
Cash inflows from investing activities (write each of them separately)	xxx	
Less: Cash outflows from investing activities (write each of them separately)	(xx)	
Net cash from Investing activities		xxx
C. Cash flow from Financing activities		
Cash inflows from investing activities (write each of them separately)	xxx	
Less: Cash outflows from investing activities (write each of them separately)	(xxx)	
Net Cash flow from Financing activities		xxx
Net increase (or decrease) in cash and cash equivalents (A +B+C)		xxx
Add: Cash and cash equivalents in the beginning of the year		xxx
Cash and cash equivalents at the end of the year		**xxx**

TREATMENT OF SPECIFIC ITEMS

★Loans/Advances given, and Interests earned

Operating Cash Flow

- In case of financial enterprises – when it is earned in the ordinary course of business.
- In case of non-financial enterprises - when Interest is earned from customers for late payments
- In case of all enterprises – when,
  - Advances given to employees and interests earned on them
  - Advance payments to suppliers and interests earned on them

Investing Cash Flow

- In case of all enterprises - when given to subsidiaries and interests earned on them
- In case of non-financial enterprises – any transaction other than mentioned under operating cash flow

★Loans/Advances taken, and Interests paid

Operating Cash Flow

- In case of financial enterprises – when it is paid in the ordinary course of business.
- In case of non-financial enterprises - when advance is taken from customers and interest paid on them
- In case of all enterprises – when,
  - Interest paid to suppliers for late payment
  - Interest taken as part of inventory cost as per AS 16

Financing Cash Flow

- In case of all enterprises – when taken from subsidiaries and interests paid on them
- In case of non-financial enterprises – any transaction other than mentioned under operating cash flow

★ Extraordinary cash flows

- Separate disclosure by classifying them as cash flows from operating, investing or financing activities, as may be appropriate.
- Insurance claims received against loss of stock or loss of profits are **extraordinary operating cash inflows.**
- Insurance claims received against loss of fixed assets are **extraordinary investing cash inflows.**

★ Investments made and dividends earned

Operating Cash Flow
- In case of financial enterprises - when it is earned in the ordinary course of business

Investing Cash Flow
- In case of non-financial enterprises – Generally.
- In case of all enterprises - Investments in subsidiaries and dividends earned on them

★ Income Tax

Operating Cash Flow
- Tax paid on operating income
- Tax deducted at source on operating income and operating expense

Investing Cash Flow
- Tax deducted at source on Investing income e.g. Interest income

Financing cash flow
- Tax deducted at source on Financing expenditure e.g. Interest paid.

★ Interest and Dividends

Operating Cash Flow
- In case of financial enterprises - interest paid and interest and dividends received

Investing Cash Flow
- In case of non-financial enterprises - interest and dividends received

Financing cash flow
- In case of all enterprises – Dividends paid

★ 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 on 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 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**.

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

★ Reporting Cash Flows on Net Basis

- Netting of receipts and payments from investing and financing activities is forbidden by AS3. i.e. cash paid on purchase of fixed assets should not be shown net of cash realised from sale of fixed assets.

- **<u>Exceptions to the above rule - For Financial enterprises</u>**
  - Cash flows on acceptance and repayment of fixed deposits with a fixed maturity date
  - Cash flows on placement and withdrawal deposits from other financial enterprises
  - Cash flows on advances/loans given to customers and repayments received there from.
- **<u>Exceptions to the above rule - For Investment companies</u>**
  - 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
  - Cash receipts and payments on behalf of customers.

DISCLOSURES

- AS 3 requires an enterprise to disclose the amount of **<u>significant cash and cash equivalent balances held by it but NOT available for its use</u>**, 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 **<u>additional information</u>**, relevant for understanding the **<u>financial position and liquidity</u>** of the enterprise together with a commentary by management. Such information may include:
  - The amount of undrawn borrowing facilities that may be available for future operating activities indicating any restrictions on the use of these facilities; and
  - The aggregate amount of cash flows required for maintaining operating capacity, e.g. additional machinery purchased to increase production.
- 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:
  - The total purchase or disposal consideration; and
  - The portion of the purchase or disposal consideration discharged by means of cash and cash equivalents.

Illustrations - CFS

Illustration 1 ***(Direct Method – CF from operating activity – III-1)***

From the following information, calculate cash flow from operating activities:

Summary of Cash Account **for the year ended March 31, 20X1**			
Particulars	**Amount (Rs.)**	**Particulars**	**Amount (Rs.)**
To Balance b/d	1,00,000	By Cash Purchases	1,20,000
To Cash sales	1,40,000	By Trade payables	1,57,000
To Trade receivables	1,75,000	By Office & Selling Expenses	75,000
To Trade Commission	50,000	By Income Tax	30,000
To Sale of Investment	30,000	By Investment	25,000
To Loan from Bank	1,00,000	By Repay of Loan	75,000
To Interest & Dividend	1,000	By Interest on loan	10,000
		By Balance c/d	1,04,000
	5,96,000		5,96,000

Illustration 2 ***(CF from Investing Activities – III – 2 : Example)***

In a year the company has made sales of Rs.10,000. From the extracts given, prepare ledger accounts to arrive at money paid by or paid to debtors and creditors respectively.

Profit and Loss Account.

Debit	(Rs.)	Credit	(Rs.)
To Purchases Cash – 2000 Credit 5000	7,000	By Sales Cash – 6000 Credit - 4000	10,000
To Bad Debt	200		

Particulars	Year 1 (Rs.)	Year 2 (Rs.)
Debtors – closing	1,000	1,200Rs.
Trade payables - closing	500	600

Illustration 3 ***(CF from Financing Activities- III – 3)***

Following are the extracts of Balance Sheet of Ajay Ltd.:

Liabilities	31.3.20X1 (Rs.)	31.3.20X2 (Rs.)	Assets	31.3.20X1 (Rs.)	31.3.20X2 (Rs.)
Share Capital	5,00,000	5,00,000	Goodwill	1,15,000	90,000
15% Debentures	5,00,000	7,50,000			
Unpaid Interest	--	5,000	Discount on issue of Debentures	90,000	1,15,000
Profit & Loss A/c	50,000	90,000			

You are required to present the cashflow from financing activity, if Discount on issue of Debentures amounting to Rs. 10,000 has been written off during the year.

Illustration 4

The following summary cash account has been extracted from the company's accounting records:

Particulars	Amount (Rs. '000)	Amount (Rs. '000)
Balance at 1.3.20X1		35
Receipts from customers		2,783
Issue of shares		300
Sale of fixed assets		128
		3,246

Payments to suppliers	2,047	
Payments for fixed assets	230	
Payments for overheads	115	
Wages and salaries	69	
Taxation	243	
Dividends	80	
Repayments of bank loan	250	(3,034)
Balance at 31.3.20X2		212

Prepare Cash Flow Statement of this company Hills Ltd. for the year ended 31st March, 20X2 in accordance with AS-3 (Revised).

The company does not have any cash equivalents.

Illustration 5

Given below is the Statement of Profit and Loss of ABC Ltd. and the relevant Balance Sheet information:

Statement of Profit and Loss of ABC Ltd. for the year ended 31st December 2013

Particulars	Rs.in lakhs
Revenue	
Sales	4150
Interest and dividend	100
Stock adjustment	20
Total Revenue(A)	**4270**
Expenditure	
Purchases	2400
Wages and salaries	800
Other expenses	200
Interest	60
Depreciation	100
Total Expenditure (B)	**3560**
Profit before tax(A-B)	**710**
Tax Provision	(200)
Profit after tax	**510**
Balance of Profit and Loss account brought forward	50
Profit available for distribution	**560**
Appropriations:	
Transfer to general reserve	200
Proposed dividend	300
Dividend Distribution Tax	30
Total Appropriations	**530**

Balance	**30**

Relevant Balance Sheet Information:

Particulars	**Closing Balance Rs. in lakhs**	**Opening Balance Rs. in lakhs**
Trade receivables	400	250
Inventories	200	180
Trade payables	250	230
Outstanding Wages	50	40
Outstanding expenses	20	10
Advance Tax	195	180
Tax Provision-Assessed tax liability	200	180

Compute cash flow from operating activities using

1. Direct method and
2. Indirect method

Illustration 6

Prepare Cash Flow Statement of M/s MNT Ltd. for the year ended 31st March, Year 1 with the help of the following information:

1. Company sold goods for cash only
2. Gross Profit Ratio was 30% for the year, gross profit amounts to Rs.3,82,500.
3. Opening inventory was less than closing inventory by Rs.35,000
4. Wages paid during the year Rs.4,92,500
5. Office & selling expenses paid during the year Rs.75,000
6. Dividend paid during the year Rs. 30,000 (including dividend distribution tax)
7. Bank loan repaid during the year Rs.2,15,000 (including interest Rs.15,000)
8. Trade payables on 31st March, Year 0 exceed the balance on 31st March Year 1 by Rs.25,000
9. Amount paid to trade payables during the year Rs.4,60,000
10. Tax paid during the year amounts to Rs.65,000 (Provision for taxation as on 31st March of Year 1 Rs.45,000)
11. Investments of Rs.7,00,000 sold during the year at a profit of Rs.20,000
12. Depreciation on fixed assets amounts to Rs.85,000
13. Plant and Machinery purchased on 15th November of Year 0 for Rs.2,50,000
14. Cash and Cash equivalents on 31st March of Year 0 - Rs.2,00,000
15. Cash and Cash equivalents on 31st March of Year 1 – Rs.6,07,500

Illustration 7

Prepare Cash flow for Gamma Ltd., for the year ending 31.3.2014 from the following information:

(1) Sales for the year amounted to Rs.135 crores out of which 60% was cash sales.

(2) Purchases for the year amounted to Rs. 55 crores out of which credit purchase was 80%.

(3) Administrative and selling expenses amounted to Rs.18 crores and salary paid amounted to Rs. 22 crores.

(4) The Company redeemed debentures of Rs. 20 crores at a premium of 10%. Debenture holders were issued equity shares of Rs. 15 crores towards redemption and the balance was paid in cash. Debenture interest paid during the year was Rs1.5 crores.

(5) Dividend paid during the year amounted to Rs. 11.7 crores (including Dividend distribution tax) was also paid.

(6) Investment costing Rs.12 crores were sold at a profit of Rs. 2.4 crores.

(7) Rs. 8 crores were paid towards income tax during the year.

(8) A new plant costing Rs. 21 crores were purchased in part exchange of an old plant. The book value of the old plant was Rs.12 crores but the vendor took over the old plant at a value of Rs.10 crores only. The balance was paid in cash to the vendor.

(9) The following balances are also provided:

	Rs. in crores 1.4.X0	Rs. in crores 31.3.X1
Debtors	45	50
Creditors	21	23
Bank	6	-

Illustration 8

From the following Balance Sheets of Mr. Zen, prepare a Cash flow statement as per AS-3 for the year ended 31.3.20X1:

Balance Sheets of Mr. Zen

Liabilities	**1.4.20X0**	**1.4.20X1**
Zen's Capital A/c	10,00,000	12,24,000
Trade payables	3,20,000	3,52,000
Mrs. Zen's loan	2,00,000	--
Loan from Bank	3,20,000	4,00,000
	18,40,000	19,76,000
Assets	**1.4.20X0**	**1.4.20X1**
Land	6,00,000	4,80,000
Plant and Machinery	6,40,000	8,80,000
Inventories	2,80,000	2,00,000
Trade receivables	2,40,000	4,00,000
Cash	80,000	56,000

	18,40,000	19,76,000

Additional information:

A machine costing Rs.80,000/- (accumulated depreciation there on 24,000/-) was sold for 40,000/-. The provision for depreciation on 1.4.20X0 was 2,00,000/- and 31.3.20X1 was 3,20,000/- The net profit for the year ended on 31.3.20X1 was 3,60,000/-.

Illustration 9

Ms. Jyoti of Star Oils Limited has collected the following information for the preparation of cash flow statement for the year ended 31st March, 20X1:

	(Rs. In lakhs)
Net Profit	25,000
Dividend (including dividend tax) paid	8,535
Provision for Income tax	5,000
Income tax paid during the year	4,248
Loss on sale of assets (net)	40
Book value of the assets sold	185
Depreciation charged to Profit & Loss Account	20,000
Profit on sale of Investments	100
Carrying amount of Investment sold	27,765
Interest income on investments	2,506
Interest expenses of the year	10,000
Interest paid during the year	10,520
Increase in Working Capital (excluding Cash & Bank Balance)	56,081
Purchase of fixed assets	14,560
Investment in joint venture	3,850
Expenditure on construction work in progress	34,740
Proceeds from calls in arrear	2
Receipt of grant for capital projects	12
Proceeds from long-term borrowings	25,980
Proceeds from short-term borrowings	20,575
Opening cash and Bank balance	5,003
Closing cash and Bank balance	6,988

Prepare the Cash Flow Statement for the year 20X1 in accordance with AS 3.

Illustration 10

The following data were provided by the accounting records of Ryan Ltd. at year-end, March 31, 20X1:

Income Statement

	(Rs.)	(Rs.)
Sales		6,98,000

Cost of Goods Sold		(5,20,000)
Gross Margin		1,78,000
Operating Expenses		
(including Depreciation Expense of Rs.37,000/-)		(1,47,000)
		31,000
Other Income / (Expenses)		
Interest Expense paid	(23,000)	
Interest Income received	6,000	
Gain on Sale of Investments	12,000	
Loss on Sale of Plant	(3,000)	
		(8,000)
		23,000
Income tax		(7,000)
		16,000

Comparative Balance Sheets

	31st March 20X1	31st March 20X0
Assets		
Plant Assets	7,15,000	5,05,000
Less: Accumulated Depreciation	(1,03,000)	(68,000)
	6,12,000	4,37,000
Investments (Long term)	1,15,000	1,27,000
Current Assets:		
Inventory	1,44,000	1,10,000
Accounts receivable	47,000	55,000
Cash	46,000	15,000
Prepaid expenses	1,000	5,000
	9,65,000	7,49,000
Liabilities		
Share Capital	4,65,000	3,15,000
Reserves and surplus	1,40,000	1,32,000
Bonds	2,95,000	2,45,000
Current liabilities:		
Accounts payable	50,000	43,000
Accrued liabilities	12,000	9,000
Income taxes payable	3,000	5,000
	9,65,000	7,49,000

Analysis of selected accounts and transactions during 20X0-X1

1. Purchased investments for Rs.78,000/-.
2. Sold investments for Rs.1,02,000/-. These investments cost Rs.90,000/-.
3. Purchased plant assets for Rs.1,20,000/-.

4. Sold plant assets that cost Rs.10,000/- with accumulated depreciation of Rs. 2,000/- for Rs.5,000/-.
5. Issued Rs.1,00,000/- of bonds at face value in an exchange for plant assets on 31st March, 20X1.
6. Repaid Rs.50,000/- of bonds at face value at maturity.
7. Issued 15,000 shares of Rs. 10/- each.
8. Paid cash dividends Rs. 8,000/-.

Prepare Cash Flow Statement as per AS-3 (Revised), using indirect method.

Illustration 11

From the following Balance Sheet and information, prepare Cash Flow Statement of Ryan Ltd. by Indirect method for the year ended 31st March, 20X1:

Liabilities	**31st March, 20X1**	**31st March, 20X0**	**Assets**	**31st March, 20X1**	**31st March, 20X0**
Equity Share Capital	6,00,000	5,00,000	Land and Building	1,50,000	2,00,000
10% Redeemable Preference Share Capital	•	2,00,000	Plant and Machinery	7,65,000	5,00,000
Capita l Redemption Reserve	1,00,000	-	Investments	50,000	80,000
Capital Reserve	1,00,000	•	Inventory	95,000	90,000
General Reserve	1,00,000	2,50,000	Trade receivables	2,50,000	2,25,000
Profit & Loss Account	70,000	50,000	Cash and Bank	65,000	90,000
9% Debentures	2,00,000	-	Voluntary Separation Payments	1,25,000	65,000
Trade payables	1,15,000	1,10,000			
Liability for Expenses	30,000	20,000			
Provision for Taxation	95,000	60,000			

Dividend Payable	90,000	60,000			
	15,00,000	**12,50,000**		**15,00,000**	**12,50,000**

Additional Information:

- A piece of land has been sold out for Rs.1,50,000 (Cost – Rs.1,20,000) and the balance land was revalued. 4960Capital Reserve consisted of profit on sale and profit on revaluation.
- On 1st April, 20X0 a plant was sold for Rs.90,000 (Original Cost – Rs.70,000 and W.D.V. – Rs.50,000) and Debentures worth Rs.1 lakh was issued at par as part consideration for plant of Rs.4.5 lakhs acquired.
- Part of the investments (Cost – Rs.50,000) was sold for Rs.70,000.
- Pre-acquisition dividend received Rs.5,000 was adjusted against cost of investment.
- Directors have declared 15% dividend for the current year.
- Voluntary separation cost of Rs.50,000 was adjusted against General Reserve.
- Income-tax liability for the current year was estimated at Rs.1,35,000.
- Depreciation @ 15% has been written off from Plant account but no depreciation has been charged on Land and Building.

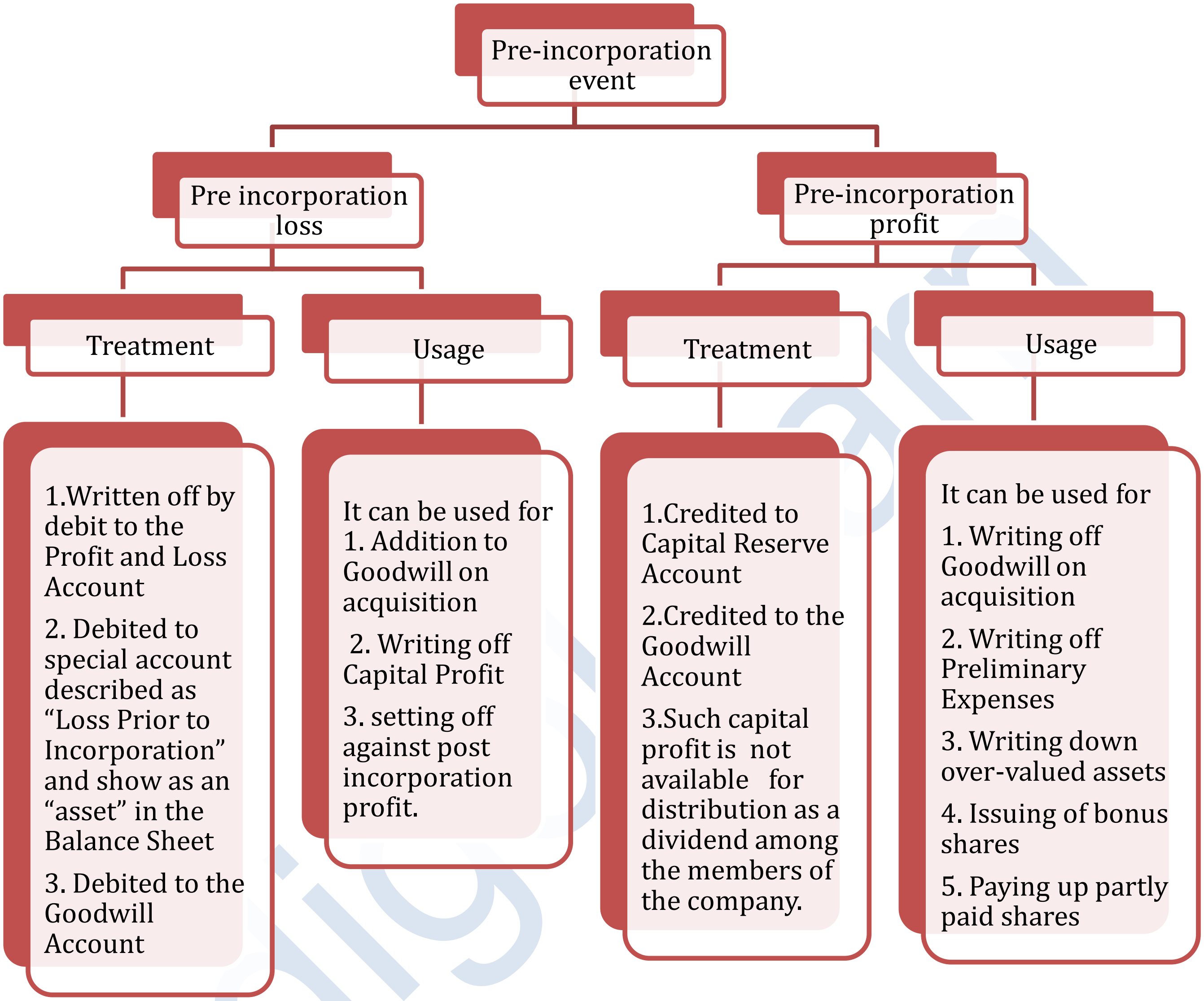
PROFIT OR LOSS ON PRE AND POST INCORPORATION PROFITS

INTRODUCTION

- When a running business is taken over by the promoters of a company, as at a date prior to the date of incorporation of company, the amount of profit or loss of such a business for the period prior to the date the company came into existence is referred to as pre-incorporation profits or losses.

- Unless the agreement with the vendors provides otherwise, such a profit or loss belongs to the company. Such profit or loss is a capital item because the company is not yet incorporated.

- Such profits or losses are of capital nature and needs to be disclosed separately.



METHODS TO ASCERTAIN PROFIT OR LOSS PRIOR TO INCORPORATION

Method of ascertainment

1. Draw Trial balances upto the date of incorporation and

2. Prepare P&L A/c upto the date of incorporation

Accurate method but inconvenient to follow as it affects normal transactions.

Hence generally not adopted in practice.

1.Draw Trial balance at the end of accounting period and

2. Prepare P&L A/c by apportionment of items in Pre and Post.

Not accurate as it is only an estimate.

Hence, generally adopted in practice.

APPORTIONMENT OF P&L ITEMS

Time basis

- All Income and Expenses are apportioned on the basis of months.
- Assumed profits are earned evenly during the period.
- Not practical as variable expenses are not related to time.

Turnover basis

- All Income and Expenses are apportioned on the basis of Turnover (in amount)
- Assumed sales are made evenly during the period.
- Not practical as fixed expenses do not varing with turnover. Further some expenses are pertain to pre incorporation period and some to post incorporation period.

Equitable basis

- Variable expenses varying with turnover are apportioned on that basis and Fixed expenses which are related to time are apportioned on the basis of time.
- Prudent method and hence used.

BASIS OF APPORTIONMENT

Items	Basis of apportionment
1. Gross profit / loss	1st Preference – Turnover 2nd Preference – cost of goods sold (if turnover information is not given) Last preference - Time (if other two information is not given)
2. All fixed expenses like Rent, Salaries, Telephone, Rates and taxes, Depreciation, Stationary etc.	Time
3. All variable expenses (linked with turnover) like commission, Discount, brokerage, Carriage outward, Selling and distribution expenses, Bad debts, Advertisement etc.	Turnover
4. Period specific items For e.g.: 4.A. Formation expenses, interest on debentures, director's fees, Directors' remuneration, Preliminary Expenses, Share issue Expenses, Underwriting commission, Discount on issue of securities 4.B. Expenses incurred only during pre-incorporation period.	Wholly on the respective periods. Charge to post-incorporation period Charge to pre-incorporation period
5. Interest on Vendor's Capital -	Charge to pre-incorporation period (but if the purchase consideration is not paid on taking over of business, interest for the subsequent period is charged to post incorporation period)
6. Interest on Purchase consideration to vendor	Time (if paid even after incorporation)
7. Audit fees Audit under Companies Act Tax audit as per sec.44AB of Income tax Act	 Post incorporation Turnover

Illustrations

Illustration – 1

Rama Udyog Limited was incorporated on August 1, 20X1.

It had acquired a running business of Rama & Co. with effect from April 1, 20X1. During the year 20X1-X2, the total sales were Rs. 36,00,000.
The sales per month in the first half year were half of what they were in the later half year.

The net profit of the company, Rs.2,00,000 was worked out after charging the following expenses:

Particulars	**Rs.**
Depreciation	1,23,000
Directors' fees	50,000
Preliminary expenses	12,000
Office expenses	78,000
Selling expenses	72,000
Interest to vendors up to August 31, 20 X1	5,000

You are required to ascertain pre-incorporation and post-incorporation profit for the year ended 31st March, 20X2.

Illustration – 2

The promoters of Glorious Ltd. took over on behalf of the company a running business with effect from 1st April, 20X1.
The company got incorporated on 1st August, 20X1. The annual accounts were made up to 31st March, 20X2 which revealed that,

- Sales for the whole year totaled Rs.1,600 lakhs out of which sales till 31st July, 20X1 were for Rs.400 lakhs.
- Gross profit ratio was 25%.

The expenses from 1st April 20X1, till 31st March, 20X2 were as follows,

Particulars	**Rs. (In Lakhs)**
Salaries	69
Rent, Rate & Insurance	24
Sundry office Expenses	66
Traveler's Commission	16
Discount Allowed	12

Bad Debts	4
Directors Fees	25
Tax Audit Fees	9
Depreciation on Tangible Assets	12
Debenture Interest	11

Prepare a statement showing the calculation of Profits for the pre-incorporation and post-incorporation periods.

Illustration - 3

The partners of Maitri Agencies decided to convert the partnership into a private limited company called MA (P) Ltd. with effect from 1st January, 20X2.

The consideration was agreed at Rs.1,17,00,000 based on the firm's Balance Sheet as at 31st December, 20X1.

However, due to some procedural difficulties, the company could be incorporated only on 1st April, 20X2.

Meanwhile the business was continued on behalf of the company and the consideration was settled on that day with interest at 12% per annum.

The same books of account were continued by the company which closed its account for the first time on 31st March, 20X3 and prepared the following summarized profit and loss account

Particulars	Rs	Rs
Sales		2,34,00,000
Less: Cost of goods sold	1,63,80,000	
Salaries	11,70,000	
Depreciation	1,80,000	
Advertisement	7,02,000	
Discounts	11,70,000	
Managing Director's remuneration	90,000	
Miscellaneous office expenses	1,20,000	
Office-cum-show room rent	7,20,000	
Interest	9,51,000	2,14,83,000
Profit		19,17,000

- The company's only borrowing was a loan of Rs.50,00,000 at 12% p.a. to pay the purchase consideration due to the firm and for working capital requirements.
- The company was able to double the average monthly sales of the firm, from 1st April, 20X2 but the salaries tripled from that date.
- It had to occupy additional space from 1st July, 20X2 for which rent was Rs.30,000 per month.

Prepare statement of apportioning cost and revenue between pre-incorporation and post-incorporation periods and calculation of profits/losses for such periods.

Illustration - 4

Inder and Vishnu, working in partnership registered a joint stock company under the name of Fellow Travellers Ltd. on May 31, 20X1 to take over their existing business.

It was agreed that they would take over the assets of the partnership from January 1st, 20X1 for a sum of Rs.3,00,000 and that until the amount was discharged, they would pay interest on the amount at the rate of 6% per annum.

- The amount was paid on June 30, 20X1.
- To discharge the purchase consideration, the company issued
- 20,000 equity shares of Rs.10 each at a premium of Rs.1 each and
- allotted 7% Debentures of the face value of Rs.1,50,000 to the vendors at par.

The summarized Profit and Loss Account of the "Fellow Travellers Ltd." for the year ended 31st December, 20X1 was as follows:

Particulars	Rs.	Particulars	Rs.
To Purchases (Incl. Inventory)	1,40,000	By Sales [	
To Freight Carriage	5,000	1 Jan – 31 May	60,000
		1 June -31 Dec	1,20,000
		By Inventory in hand	25,000
To Gross Profit c/d.	60,000		-
	2,05,000		**2,05,000**
To Salaries & Wages	10,000	By Gross Profit b/d.	60,000
To Debenture Interest	5,250		
To Depreciation	1,000		
To Interest on Purchase	9,000		

[Consideration (up to 30 -6-20X1)			
To Selling Commission	9,000		
To Directors Fee	600		
To Preliminary Expenses.	900		
To Provision for Taxes (entirely related with company)	6,000		
To Dividend paid on Equity shares @ 5%	5,000		
To balance c/d	13,250		
	60,000		**60,000**

Prepare statement apportioning the expenses and calculate profits/losses for the 'post' and 'pre-incorporation' periods and show how these figures would appear in the Balance Sheet of the company.

Illustration - 5

ABC Ltd. took over a running business with effect from 1st April, 20X1.

The company was incorporated on 1st August, 20X1.

The following summarised Profit and Loss Account has been prepared for the year ended 31.3.20X2:

Particulars	Rs.	Particulars	Rs.
To Salaries	48,000	By Gross Profit b/d	3,20,000
To Stationery	4,800		
To Travelling expenses	16,800		
To Advertisement	16,000		
To Miscellaneous trade expenses	37,800		
To Rent (office buildings)	26,400		
To Electricity charges	4,200		
To Director's fee	11,200		
To Bad debts	3,200		
To Commission to selling agents	16,000		
To Tax Audit fee	6,000		
To Debenture interest	3,000		

To Interest paid to vendor	4,200		
To Selling expenses	25,200		
To Depreciation on fixed assets	9,600		
To Net Profit	87,600		
	3,20,000		3,20,000

Additional information:

(a) Total sales for the year, which amounted to Rs.19,20,000 arose evenly up to the date of 30.9.20X1. Thereafter they recorded an increase of two-third during the rest of the year.

(b) Rent of office building was paid @ Rs. 2,000 per month up to September, 20X1 and thereafter it was increased by Rs.400 per month.

(c) Travelling expenses include Rs.4,800 towards sales promotion.

(d) Depreciation include Rs 600 for assets acquired in the post incorporation period.

(e) Purchase consideration was discharged by the company on 30th September, 20X1 by issuing equity shares of Rs.10 each.

Prepare a statement showing Calculations of profit and allocation of expenses between pre and post incorporation period.

Illustration 6

ABC Ltd. was incorporated on 1.5.20X1 to take over the business of DEF and Co. from 1.1.20X1.

The summarized Profit and Loss Account as given by ABC Ltd. for the year ending 31.12.20X1 is as under:

Particulars	Rs.	Particulars	Rs.
To Rent and Taxes	90,000	By Gross Profit	10,64,000
To Salaries (including manager's salary of Rs. 85,000)	3,31,000	By Interest on Investments	36,000
To Carriage Outwards	14,000		
To Printing and Stationery	18,000		
To Interest on Debentures	25,000		

To Sales Commission	30,800		
To Bad Debts (related to sales)	91,000		
To Underwriting Commission	26,000		
To Preliminary Expenses	28,000		
To Audit Fees	45,000		
To Loss on Sale of Investments	11,200		
To Net Profit	3,90,000		
	11,00,000		11,00,000

Prepare a Statement showing allocation of expenses and calculations of pre-incorporation and post-incorporation profits after considering the following information:

(i) G.P. ratio was constant throughout the year.

(ii) Sales for January and October were 1.5 times the average monthly sales while sales for December were twice the average monthly sales.

(iii) Bad Debts are shown after adjusting a recovery of Rs.7,000 of Bad Debt for a sale made in July, 20X0.

(iv) Manager's salary was increased by Rs.2,000 p.m. from 1.5.20X1.

(v) All investments were sold in April, 20X1.

(vi) The entire audit fees relate to the company.

ACCOUNTING FOR BONUS ISSUE AND RIGHTS ISSUE

INTRODUCTION

BONUS ISSUE

- ★ Bonus issue means an issue of free additional shares to existing shareholders, without the additional inflow of cash.
- ★ It is based upon the number of shares that the shareholder already owns.
- ★ With bonus issue
  - ➢ The number of shares increases
  - ➢ There is no change in net worth of the company
  - ➢ There is no change in ratio of number of shares held.
- ★ Also known as Capitalization of profits, as it involves converting free reserves into paid up capital. {Free reserves are those which are otherwise available for distribution as dividends}
- ★ If it exceeds the authorized share capital, then a resolution is passed in General meeting for increasing the authorized capital.

PROVISIONS UNDER COMPANIES ACT, 2013

- ★ **Sec 63(1)** - a company may issue fully paid-up bonus shares to its members, in any manner out of –
  - ➢ its free reserves;
  - ➢ the securities premium account; or
  - ➢ the capital redemption reserve account.

- ★ However, **no issue** of bonus shares shall be made by capitalizing reserves created by the **revaluation of assets. [Also provided in Regulation 94 of** SEBI (Issue of Capital and Disclosure Requirements) Regulations,2009:

- ★ **Sec 63(2) -** No company shall capitalise its profits or reserves for the purpose of issuing fully paid-up bonus shares unless –
  1) It is authorised by its articles;

2) It has, on the recommendation of the Board, been authorised in the general meeting of the company;
3) It has not defaulted in payment of interest or principal in respect of fixed deposits or debt securities issued by it;
4) It has not defaulted in respect of the payment of statutory dues of the employees, such as, contribution to provident fund, gratuity and bonus;
5) The partly paid-up shares, if any outstanding on the date of allotment, are made fully paid-up;

> ★ Free reserves may be used for paying up amounts unpaid on shares held by existing shareholders, though securities premium account and capital redemption reserve cannot be used.

★ The company which has once announced the decision of its Board recommending a bonus issue, shall not subsequently withdraw the same. [Rule 14 of Companies (Share Capital and Debentures) Rules, 2014]

★ <u>Sec 63(3) -</u> The bonus shares shall not be issued in lieu of dividend. **[Also provided in Regulation 94 of** SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2009

<u>PROVISIONS UNDER SEBI REGULATIONS</u>

A listed company, while issuing bonus shares to its members, must comply with the following requirements under the SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2009:

★ **<u>Regulation 92- Conditions for Bonus Issue</u>**

- Points 1, 3, 4 and 5 provided in Sec 63(2) (mentioned above) are also provided in regulation 92.

★ **<u>Regulation 93 - Restriction on bonus issue</u>**

- Every listed company must make reservation of same class equity shares in favor of the holders of outstanding compulsorily convertible debt instruments, if any, in proportion to the convertible part thereof.
- Such reserved shares shall be issued at the time of conversion of such convertible debt instruments on the same terms or same proportion at which the bonus shares were issued.

★ **Regulation 94 - Bonus shares provision**

- The bonus issue shall be made from
  - free reserves built out of the genuine profits or
  - securities premium collected in cash only
- The bonus issue shall not be made from reserves created by revaluation of fixed assets
- The bonus share shall not be issued in lieu of dividend.

★ **Regulation 95 - Completion of bonus issue**

- Implementation of bonus issue
  - Within 15 days from the date of approval of the issue by its board – when bonus issue is announced after the approval of its board of directors and not requiring shareholders' approval
  - within 2 months from the date of the meeting of its board - where the issuer is required to seek shareholders' approval.
- Once the decision to make a bonus issue is announced, the issue cannot be withdrawn.

Journal entries	
Upon the sanction of an issue of bonus shares	
Capital Redemption Reserve A/c	Dr.
Securities Premium A/c	Dr.
General Reserve A/c	Dr.
Profit & Loss A/c	Dr.
To Bonus to Shareholders A/c	
Upon issue of bonus shares	
Bonus to Shareholders A/c	Dr.
To Share Capital A/c	
Upon the sanction of bonus by converting partly paid shares into fully paid shares	
General Reserve A/c	Dr.
Profit & Loss A/c	Dr.
To Bonus to Shareholders A/c	
On making the final call due	
Share Final Call A/c	Dr.
To Share Capital A/c	
On adjustment of final call	
Bonus to Shareholders A/c	Dr.
To Share Final Call A/c	

RIGHT ISSUE

- ★ Right issue is an issue of rights to a company's existing share- holders that entitles them to buy additional shares directly from the company in proportion to their existing holdings, within a fixed time period.

  This way the voting and governance rights of the existing shareholders is not diluted.
- ★ In a right offering, the subscription price at which each share may be purchased is generally at a discount to the current market price.
- ★ Rights are often transferable, allowing the holder to sell them in the open market.
- ★ They have an implicit right to renounce this right in favor of someone else (unless the articles restrict such a right), or even reject it completely. When the existing shareholder charges for the renouncement, it is called the value of right.
- ★ The difference between the cum-right and ex-right value of the share is the value of the right.

PROVISIONS UNDER COMPANIES ACT, 2013

★ **Sec 62(1) - Conditions for issuing letter of offer**

The offer is made by a notice to shareholder which consists the following:

- ➢ The number of shares offered
- ➢ The time limit not being less than fifteen days and not exceeding thirty days from the date of the offer within which the offer should be accepted.
- ➢ If time limit expires, the offer is deemed to be declined
- ➢ Unless the articles otherwise provide, the offer aforesaid shall be deemed to include a right exercisable by the person concerned to renounce the shares offered to him or any of them in favor of any other person.
- ➢ After the expiry of the time specified in the notice or on receipt of earlier intimation of rejection from the shareholder the Board of Directors may dispose of them in a manner which is not disadvantageous to the shareholders.

★ **Exceptions to Sec 62** –Cases where shares are issued by a company, but not be offered to the existing shareholders –

1) To employees under a scheme of employees' stock option subject to certain specified conditions
2) To any persons, either for cash or for a consideration other than cash, if the price of such shares is determined by the valuation report of a registered valuer subject

to certain specified conditions.

3) When companies borrow money through debentures / loans and give their lender an option to convert them into equity shares.
4) In a special situation where the loan has been obtained from the government, and government in public interest, directs the debentures / loan to be converted into equity shares.

COMPUTATION OF VALUE OF RIGHT

Book value of a share = Net worth (as per books) ÷ Number of shares

Market price, which exists before the rights issue, is termed as Cum-right Market Price of the share.

The market price of the shares after further issue of shares (right issue) is termed as Ex- right Market Price of the shares.

This price is going to prevail after the further issue of shares is executed

Ex-right value of the shares = [Cum-right value of the existing shares + (Rights shares X Issue Price)] ÷ (Existing Number of shares + Number of right shares)

Value of right = Cum-right value of share – Ex-right value of share

Market value of a company's shares represents the present value of future cash flows expected to be earned from the share in the form of dividends and capital gains from expected future share price appreciation.

The Ex-right value of the share is also known as the average price.

The accounting treatment of rights share is the same as that of issue of ordinary shares.

Journal entries	
Upon the issue of Right shares Bank A/c To Equity Share Capital A/c	 Dr.
In case shares are offered at premium Bank A/c To Equity Share Capital A/c To Securities premium A/c	 Dr.

RIGHT OF RENUNCIATION

★ Right of renunciation refers to the right of the shareholder to surrender his right to buy the securities and transfer such right to any other person.

★ Shareholders that have received right shares have three choices
  - ➢ They can act on the rights and buy more shares as per the particulars of the rights issue;
  - ➢ They can sell them in the market; or
  - ➢ They can pass on taking advantage of their rights (i.e., reject the right offer).

★ The renunciation of the right is valuable and can be monetized by the existing shareholders in well-functioning capital market which is known as 'value of right'.

★ Value of right = Cum-right value of share – Ex-right value of share

ADVANTAGES OF RIGHT ISSUE

1) Enables the existing shareholders to maintain their proportional holding in the company and retain their financial and governance rights.
2) It works as a deterrent to the management, which may like to issue shares to known persons with a view to have a better control over the company's affairs.
   - The existing shareholders are not affected by the dilution because getting new shares at a discounted value from their cum-right value will compensate decrease in the value of shares.
3) Right issue is a natural hedge against the issue expenses normally incurred by the company in relation to public issue.
4) Right issue has an image enhancement effect, as public and shareholders view it positively.
5) The chance of success of a right issue is better than that of a general public issue

and is logistically much easier to handle.

DISADVANTAGES OF RIGHT ISSUE

1) The right issue invariably leads to dilution in the market value of the share of the company.
2) The attractive price of the right issue should be objectively assessed against its true worth to ensure that you get a bargained deal.

Illustrations

Illustration – 1

Following items appear in the trial balance of Bharat Ltd. (listed company) as on 31st March, 20X1:

Particulars	Amount (Rs.)
40,000 Equity shares of Rs. 10 each	4,00,000
Capital Redemption Reserve	55,000
Securities Premium (collected in cash)	30,000
General Reserve	1,05,000
Surplus i.e. credit balance of Profit and Loss Account	50,000

The company decided to issue to equity shareholders bonus shares at the rate of 1 share for every 4 shares held and for this purpose, it decided that there should be the minimum reduction in free reserves. Pass necessary journal entries.

Illustration – 2

Following is the extract of the Balance Sheet of Solid Ltd. as at 31st March, 20X1:

Particulars	Amount (Rs.)
Authorised capital:	
10,000 12% Preference shares of Rs. 10 each	1,00,000
1,00,000 Equity shares of Rs. 10 each	10,00,000
	11,00,000
Issued and Subscribed capital:	
8,000 12% Preference shares of Rs. 10 each fully paid	80,000
90,000 Equity shares of Rs. 10 each, Rs. 8 paid up	7,20,000
Reserves and Surplus:	
General reserve	1,60,000
Revaluation reserve	35,000
Securities premium (collected in cash)	20,000
Profit and Loss Account	2,05,000
Secured Loan:	
12% Debentures @ Rs. 100 each	5,00,000

On 1st April, 20X1 the Company has made final call @ Rs. 2 each on 90,000 equity shares. The call money was received by 20th April, 20X1.

Thereafter the company decided to capitalize its reserves by way of bonus at the rate of one share for every four shares held. Show necessary entries in the books of the company and prepare the extract of the Balance Sheet immediately after bonus issue if the company has passed necessary resolution at its general body meeting for increasing the authorized capital.

Illustration – 3

A company offers new shares of Rs. 100 each at 25% premium to existing shareholders on one for four bases. The cum-right market price of a share is Rs. 150. Calculate the value of a right. What should be the ex-right market price of a share?

REDEMPTION OF PREFERENCE SHARES

INTRODUCTION

- ★ Redemption is the process of repaying an obligation, at pre-arranged amounts and timings.
- ★ These shares are issued on the terms that shareholders will at a future date be repaid the amount which they invested in the company (along with frequent payment of a specified amount as return on investment during the tenure of the preference shares).
- ★ The redemption date is the maturity date, which specifies when repayment takes place and is usually printed on the preference share certificate.

REASONS FOR ISSUING REDEEMABLE PREFERENCE SHARES

1. There is difficulty in issuing equity shares, if shares are not traded in stock market and potential investors are skeptical in investing money.
2. Utilizing surplus funds in redeeming capital when they cannot use more beneficially.

SEC 55 OF COMPANIES ACT, 2013

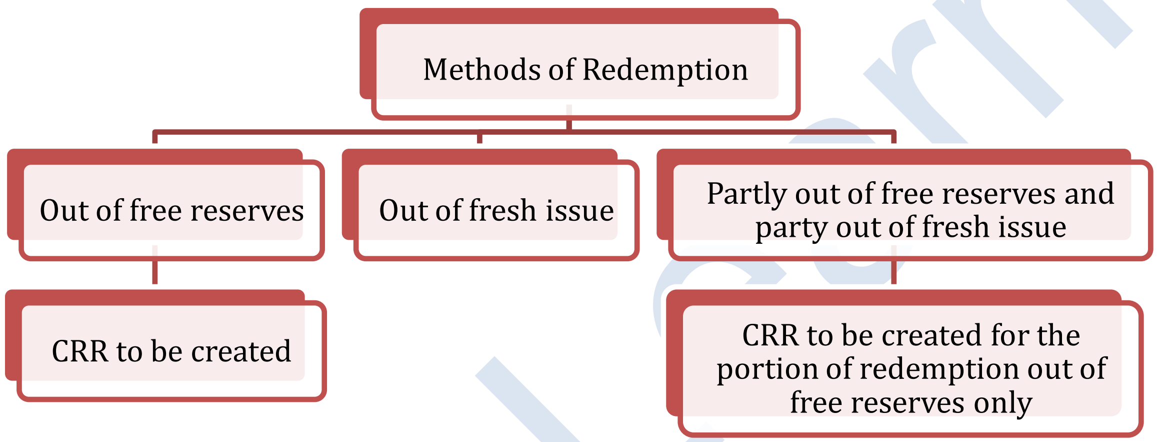
1) Issue of Preference shares should be authorized by Articles.
2) Such shares should be redeemable within a period not exceeding 20 years from the date of issue.
3) Only fully paid up shares can be redeemed.

> Note –
> If the question has partly paid shares, then due entry for final call and receipt entry is passed before redemption entry.
> If the question has both the fully paid and partly paid shares, then only fully paid is considered for redemption.

4) If any premium is payable on redemption, the same shall be provided for out of the profits of the company or out of the company's securities premium account, before such shares are redeemed.
5) However, in case of companies which are prescribed and who comply with sec 133 of Companies act 2013, premium payable on redemption, shall be provided for out of the

profits of the company only. i.e... Securities premium cannot be used.

6) Shares can be redeemed out of profit of the company which would otherwise be available for dividend or out of proceeds of fresh issue of shares made for the purpose of redemption.
7) Where shares are proposed to be redeemed out of the free reserves, a sum equal to the nominal amount of the shares redeemed should be transferred to a reserve account called Capital Redemption Reserve Account (CRR A/c)



CREATION OF CRR (CAPITAL REDEMPTION RESERVE), AND FRESH ISSUE

1) CRR can be used only for issuing fully paid bonus shares only.
2) The objective of creating CRR is to provide assurance or security to creditors/ bankers, etc.
3) Some examples of Free reserves are – General reserve, Profit and loss a/c, Surplus a/c, Residuary reserve, Dividend equalization reserve, Excess provision created etc. There is no order in which free reserves are to be utilized to create CRR.
4) Fresh issue can be either of equity shares or preference shares.
5) The proceeds of a fresh issue of shares will not include the amount of securities premium for the purpose of redemption of preference shares. (securities premium can be utilized only as per Sec 52* of Companies Act, 2013)
6) Proceeds from the issue of Debentures cannot be utilized.
7) Companies may have sufficient investments, which can be sold, in the market to arrange funds for redemption of preference shares.
8) When shares are redeemed by combination of Fresh Issue and capitalisation of Undistributed Profits:

Amount to be Transferred to Capital Redemption Reserve	
Face value of shares redeemed	xxx
Less: Proceeds from new issue	xxx

	xxx

Proceeds to be collected from New issue	
Face value of shares redeemed	xxx
Less: Profits available for distribution as dividend	xxx
	xxx

* **Sec 52 of Companies Act, 2013** - The securities premium account may be applied by the company -

(a) Towards issue of un-issued shares of the company to be issued to members of the company as fully paid bonus securities

(b) To write off preliminary expenses of the company

(c) To write off the expenses of, or commission paid, or discount allowed on any of the securities or debentures of the company

(d) To provide for premium on the redemption of redeemable preference shares or debentures of the company.

(e) For the purchase of its own shares or other securities.

> Certain class of Companies whose financial statements comply with the Accounting Standards as prescribed under Section 133 of the Companies Act, 2013, can't apply the securities premium account for the purposes (b) and (d) mentioned above.

REASONS FOR ISSUE OF EQUITY SHARES FOR THE PURPOSE OF REDEMPTION

1) When the company realizes that the capital is needed permanently, and issue of Equity Shares are better as they don't carry any fixed rate of dividend.
2) When the balance of free reserves is insufficient.
3) When the liquidity position of the company is not good enough.

ADVANTAGES AND DISADVANTAGES OF REDEMPTION OF PREFERENCE SHARES BY ISSUE OF FRESH EUQITY SHARES

Advantages	Disadvantages
1. No cash outflow of money	1. There will be dilution of future earnings
2. New equity shares may be valued at a premium	2. Shareholding in the company is changed
3. Shareholders retain their equity interest	

Journal entries	
When new shares are issued at par Bank A/c To Share Capital A/c (Being the issue of ……. shares of Rs.……each for the purpose of redemption of Preference shares, as per Board's Resolution No…… dated…….)	 Dr.
When new shares are issued at premium Bank A/c To Share Capital A/c To Securities premium A/c (Being the issue of ……. shares of Rs.……each at a premium of Rs.……each for the purpose of redemption of preference shares as per Board's Resolution No…. dated……)	 Dr.
When preference shares are redeemed at par Redeemable Preference Share Capital A/c To Preference Shareholders A/c (Being the amount payable on redemption of preference shares transferred to Preference Shareholders Account)	 Dr.
When preference shares are redeemed at a premium Redeemable Preference Share Capital A/c Premium on Redemption of Preference Shares A/c To Preference Shareholders A/c (Being the amount payable on redemption of preference shares (with premium on redemptions) transferred to Preference Shareholders Account	 Dr. Dr.
When payment is made to preference shareholders Preference Shareholders A/c To Bank A/c (Being the amount paid on redemption of preference shares)	 Dr.
For adjustment of premium on redemption Profit and Loss A/c	 Dr.

To Premium on Redemption of Preference Shares A/c (Being Premium on redemption transferred to P&L A/c)

ADVANTAGES AND DISADVANTAGES OF REDEMPTION OF PREFERENCE SHARES BY CAPITALISATION OF UNDISTRIBUTED PROFITS

Advantages	**Disadvantages**
1. No change in the percentage of equity shareholding of the company	1. There may be a reduction in liquidity
2. Surplus funds can be used	

Journal entries	
Entry for redemption of Preference shares (at par or at premium), payment to preference shareholders and adjustment of premium on redemption with the Profit and loss account is same as given above.	
For transferring nominal amount of shares redeemed to Capital Redemption Reserve Account General Reserve A/c Profit and Loss A/c To Capital Redemption Reserve A/c (Being the amount transferred to Capital Redemption Reserve Account as per the requirement of the Act).	Dr. Dr.

COMPLIANCE OF SEC.55 UNDER VARIOUS SCENARIOS

Scenarios	**Compliance with Sec 55**
1. When redemption is done with Company's own resources	Create CRR equal to the value of nominal value of shares issued. (Even if they are redeemed at premium)
2. When redemption is done by fresh issue of new shares	New shares are issued such that nominal value of shares issued = nominal value of shares redeemed.
	When Equity shares are not fully called up, only the called-up portion is considered for computing the balance of P&L to be utilized.
3. When minimum fresh issue of	**Step 1 -** Ascertain maximum amount of

shares needs to be computed	reserves and surplus available for redemption from the balance sheet and additional information given in the question. **<u>Step 2</u>** - Adjust premium on redemption payable out of profits in the reserves. **<u>Step 3</u>** - Minimum Proceeds of Fresh Issue of shares = Nominal value of preference shares to be redeemed – Maximum amount of reserve and surplus available for redemption **<u>Step 4</u>** - Minimum Number of Shares = Minimum proceeds to comply with Section 55÷ Face value of one share (Fraction is rounded off to next higher figure) In step 4, face value is considered even if shares are issued at premium. However, in case of issue of share at a discount, discounted value is considered.
4. When shares are issued at premium and redemptions is also at premium	When Securities premium including premium on fresh issue is comparatively more than premium on redemption, profits available for redemption are not required for paying premium on redemption of preference shares. Thus, in the above equation, premium on redemption is not adjusted in maximum amount of reserves and surplus available for redemption.
5. When shares are issued at premium and redemptions is also at premium. (The premium on issue is higher than the premium on redemption)	Follow the steps given in scenario 3
6. When the cash available for redemption is short	**<u>Step1</u>** - Fresh issue (Rs.) = Amount payable to preference shareholders – amount available **<u>Step 2</u>** - Fresh issue (no. of shares) = Fresh issue (above) ÷ issue price per share (including premium)

REDEMPTION OF FULLY CALLED BUT PARTLY PAID-UP PREFERENCE SHARES

★ **When calls-in-arrears is received by the company**

On receipt of amount of unpaid calls		
Bank A/c		Dr.
To Calls in arrears A/c		

After receipt of calls in arrears, the shares become fully paid up and, then, company can proceed with redemption in the normal course.

★ **In case of Forfeited Shares**

When calls in arrears is not received and redemption is due, the board may decide to forfeit the shares. The below forfeiture entry is passed before redemption entry.

On forfeiture of shares		
Share Capital A/c		Dr.
To Share forfeiture A/c		
To Calls in arrears A/c		

Illustrations

Illustration - 1

Hinduja Company Ltd. had 5,000, 8% Redeemable Preference Shares of Rs. 100 each, fully paid up. The company decided to redeem these preference shares at par by the issue of sufficient number of equity shares of Rs. 10 each fully paid up at par.

You are required to pass necessary Journal Entries including cash transactions in the books of the company.

Illustration - 2

C Ltd. had 10,000, 10% Redeemable Preference Shares of Rs. 100 each, fully paid up. The company decided to redeem these preference shares at par, by issue of sufficient number of equity shares of Rs. 10 each at a premium of Rs. 2 per share as fully paid up.

You are required to pass necessary Journal Entries including cash transactions in the books of the company.

Illustration - 3

The Board of Directors of a Company decide to issue minimum number of equity shares of Rs. 9 to redeem Rs. 5,00,000 preference shares. The maximum amount of divisible profits available for redemption is Rs. 3,00,000. Calculate the number of shares to be issued by the company to ensure that provisions of Section 55 are not violated. Also determine the number of shares if the company decides to issue shares in multiples of Rs. 50 only.

Illustration - 4

The Balance Sheet of X Ltd. as on 31st March, 20X3 is as follows:

Particulars	Amount (Rs.)
EQUITY AND LIABILITIES	
1. Shareholders' funds	
a Share capital	2,90,000
b Reserves and Surplus	48,000
2. Current liabilities	
Trade Payables	56,500
Total	**3,94,500**
ASSETS	
1. Fixed Assets	
Tangible asset	3,45,000
Non-current investments	18,500

2. Current Assets	
Cash and cash equivalents (bank)	31,000
Total	**3,94,500**

The share capital of the company consists of Rs. 50 each equity shares of Rs. 2,25,000 and Rs. 100 each Preference shares of Rs. 65,000 (issued on 1.4.20X1

The necessary Journal Entries to record the above transactions and prepare the balance sheet as on completion of the above transactions.

Illustration - 5

The following are the extracts from the Balance Sheet of ABC Ltd. as on 31st December, 20X1.

Particulars	Amount (Rs.)
Share capital:	
40,000 Equity shares of Rs. 10 each **fully paid**	Rs. 4,00,000
1,000,10% Redeemable preference share s of Rs. 100 each **fully paid**	Rs. 1,00,00
Reserve & Surplus:	
Capital reserve	Rs. 50,000
Securities premium	Rs. 50,000
General reserve	Rs. 75,000
Profit and Loss Account	Rs. 35,000

On 1st January 20X2, the Board of Directors decided to redeem the preference shares **at par** by utilization of reserve.

You are required to pass necessary Journal Entries including cash transactions in the books of the company.

Illustration - 6

C Limited had:

3,000, 12% Redeemable Preference Shares of Rs. 100 each, fully paid up
The company had to redeem these shares at a premium of 10%
It was decided by the company to issue the following: • 25,000 Equity Shares of Rs. 10 each at par • 1,000 14% Debentures of Rs. 100 each

The issue was fully subscribed, and all amounts were received in full. The payment was duly made. The company had sufficient profits.

Show Journal Entries in the books of the company.

Illustration – 7

The capital structure of a company consists of:

Particulars	Amount (Rs.)
20,000 Equity Shares of Rs. 10 each **fully paid up**	
1,000 8% Redeemable Preference Shares of Rs. 100 each **fully paid up** (issued on 1.4.20X1).	
Undistributed reserve and surplus stood as:	
General Reserve	Rs. 80,000
Profit and Loss Account	Rs. 20,000
Investment Allowance Reserve (out of which Rs. 5,000, not free for distribution as dividend)	Rs. 10,000
Securities Premium	Rs. 2,000
Cash at bank	Rs. 98,000

Preference shares are to be redeemed at a Premium of 10% and for the purpose of redemption, the directors are empowered to make fresh issue of Equity Shares at par after utilizing the undistributed reserve and surplus, subjected to the conditions that a sum of Rs. 20,000 shall be retained in general reserve and which should not be utilized.

Pass Journal Entries to give effect to the above arrangements and show how the relevant items will appear in the Balance Sheet of the company after the redemption carried out.

Illustration - 8

The Balance Sheet of XYZ as at 31st December, 20X1 inter alia includes the following:

Particulars	Amount (Rs.)
50,000, 8% Preference Shares of Rs. 100 each, **Rs. 70 paid up**	35,00,000
1,00,000 Equity Shares of Rs. 100 each **fully paid up**	1,00,00,000
Securities Premium	5,00,000
Capital Redemption Reserve	20,00,000
General Reserve	50,00,000

Under the terms of their issue, the preference shares are redeemable on 31st March, 20X2 at 5% premium.

In order to finance the redemption, the company makes,Rights issue of 50,000 equity shares of Rs. 100 each at Rs. 110 per share

Rs. 20 being payable on application
Rs. 35 (including premium) on allotment
Balance on 1st January, 20X3

1. The issue was fully subscribed, and allotment made on 1st March, 20X2. The money due on allotment were received by 31st March, 20X2.
2. The preference shares were redeemed after fulfilling the necessary conditions of Section 55 of the Companies Act, 2013.

You are asked to pass the necessary Journal Entries and show the relevant extracts from the balance sheet as on 31st March, 20X2 with the corresponding figures as on 31st December, 20X1

Illustration 9

The Balance Sheet of XYZ Ltd. as at 31st December, 20X1 inter alia includes the following information:

Particulars	Rs.
50,000, 8% Preference Shares of Rs.100 each, Rs.70 paid up	35,00,000
1,00,000 Equity Shares of Rs.100 each fully paid up	1,00,00,000
Securities Premium	5,00,000
Capital Redemption Reserve	20,00,000
General Reserve	50,00,000
Bank	15,00,000

Under the terms of their issue, the preference shares are redeemable on 31st March, 20X2 at 5% premium. In order to finance the redemption, the company makes a rights issue of 50,000 equity shares of Rs. 100 each at Rs. 110 per share, Rs. 20 being payable on application, Rs. 35 (including premium) on allotment and the balance on 1st January, 20X3.

The issue was fully subscribed and allotment made on 1st March, 20X2. The money due on allotment were duly received by 31st March, 20X2. The preference shares were redeemed after fulfilling the necessary conditions of Section 55 of the Companies Act, 2013.

Assume that the Preference Shareholders holding 2,000 shares fail to make the payment for the Final Call made under Section 55, you are asked to pass the necessary Journal Entries and show the relevant extracts from the balance sheet as on 31st March, 20X2 with the corresponding figures as on 31st December, 20X1 assuming that the shares in default are forfeited after giving proper notices.

REDEMPTION OF DEBENTURES

INTRODUCTION

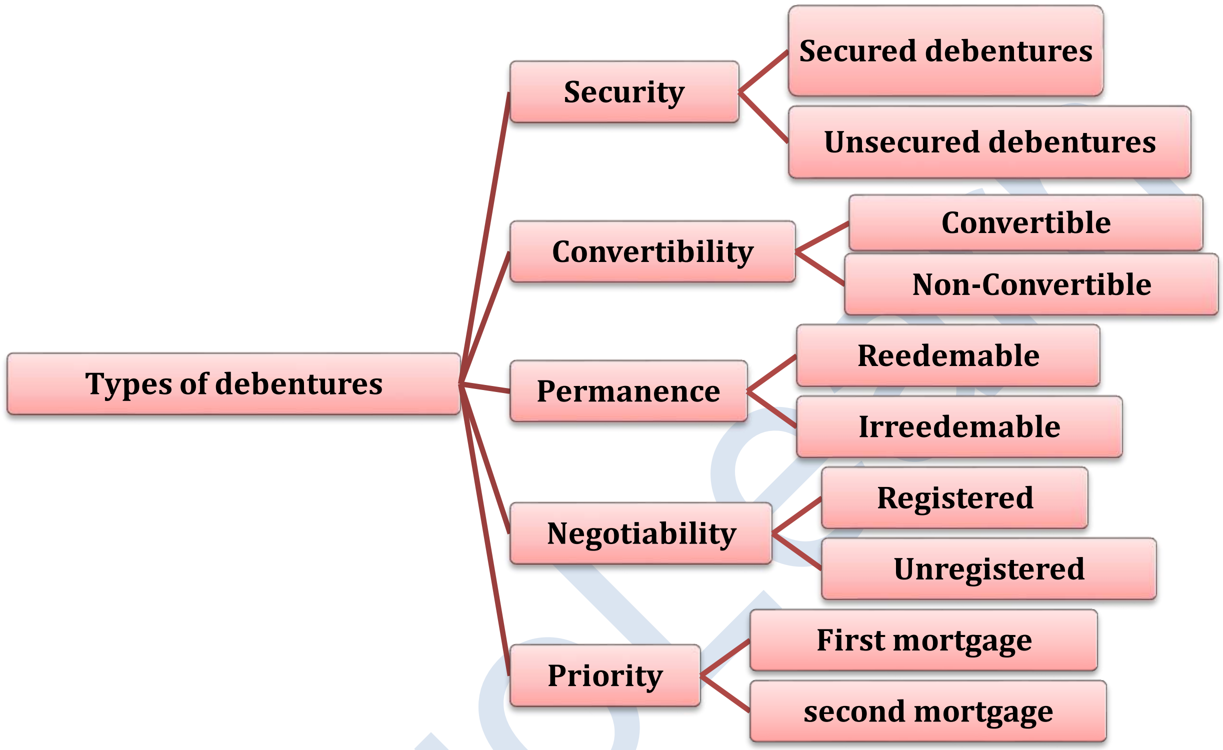
- ★ A debenture is an instrument issued by a company under its seal, acknowledging a debt and containing provisions as regards repayment of the principal and interest
- ★ It's a long-term debt for the company. They are commonly secured by charge. Thus, they appear under "Secured Liabilities".
- ★ If a charge has been created on any or the entire asset of the company, the nature of the charge and the asset charged therein are described in the bond. The certificate registering the charge with the registrar is also printed on the bond.
- ★ A trusteeship in favor of one or more persons in the case of mortgage debentures is created. The trustees of debenture holders can take any action necessary to safeguard the interest of debenture holders.
- ★ It earns a fixed income in form of interest. Interest is payable by the company whether it earns profit or not.
- ★ The procedure for issue of debentures is similar to that of issue of shares. Thus, the amount can be collected in lumpsum along with application or in instalments.
- ★ In case of oversubscription, the excess applications must be rejected, and the amount should be refunded. The excess money cannot be adjusted as in case of shares.
- ★ They can be issued for
  - ➢ Cash
  - ➢ Consideration other than cash.
  - ➢ As collateral security.
- ★ They can be issued at
  - ➢ Par
  - ➢ Premium
  - ➢ At discount
- ★ The terms of redemption should also be accounted at the time of issue. Redemption of debentures at a premium is a known loss at the time of issue of debentures as the terms of issue generally contain such provisions for redemption.

PROVISION OF COMPANIES ACT 2013

- ★ **Sec.71(1)** - A company may issue debentures with an option to convert such debentures into shares, either wholly or partly at the time of redemption. Provided the issue of convertible debentures is approved by a special resolution passed at a duly convened general meeting.
- ★ **Sec.71 (2)** -No company can issue any debentures which carry any voting rights.

★ **Sec.71(4)-**The company should create a debenture redemption reserve account (DRR) out of free reserves and the amount credited to such account should not be utilized by the company for any purpose other than the redemption of debentures.

TYPES OF DEBENTURES



Redeemable debentures - Debentures, which can be redeemed or for which payment is made after a specified time are called Redeemable debentures.

These are redeemable-

(i) At the expiry of a specified period either at par or at a premium;

(ii) By purchasing in the open market at any time at the price prevailing in the market; and

(iii) By annual drawings.

Irredeemable debentures - When the issuing company does not fix any date by which debentures can be redeemed, and the holders of such debentures cannot demand payment from the company so long as it is a going concern it is called irredeemable debentures. Usually such debentures are repayable after a long period of time or when the company decides to wind up.

First debentures: - Those debentures, which are repaid before other debentures are paid out, are called First debentures.

Second debentures: - Those debentures, which are paid after the payment towards the First debenture, are called Second debentures.

Convertible debentures: - Those debentures, which are given the option to convert the debentures fully or partly into equity shares after a specified time, are called Convertible Debentures. If the debentures are fully converted, then it is called as 'Fully Convertible debentures. those which are partly convertible are called 'Partly Convertible debentures.

Non-convertible Debentures: - The debentures that cannot be converted into equity shares such are non-convertible debentures.

Mortgage Debentures: - Debentures, which are secured either on a particular asset [called fixed charge], or on the general assets of the company [called floating charge], are called Mortgage debentures.

Unsecured / Naked Debentures: - Those debentures which are not secured, are called naked debentures. Companies with very good standing can issue such debentures.

Registered Debentures – Those which are registered with the Registrar

Unregistered Debentures – Those which are not registered with the registrar.

DEBENTURE REDEMPTION RESERVE - SEC 71 OF COMPANIES ACT 2013

(1) Where a company issues debenture under this section, it should **create a Debenture Redemption Reserve (DRR) account** out of its profits which are available for distribution of dividend **every year** until such debentures are redeemed.
(2) If Debentures are **redeemed at a premium**, DRR is created for an amount including redemption amount.
(3) The amounts credited to the debenture redemption reserve **should not be utilized** by the company except for the purpose aforesaid.
(4) The company should **pay interest and redeem the debentures** in accordance with the terms and conditions of their issue.
(5) In **case of failure** by the company, the **Tribunal** may, on the application of any or all the holders of debentures or debenture trustee and, after hearing the parties concerned, direct, by **order**, the company to redeem the debentures forthwith by the payment of principal and interest due thereon.
(6) The company can create an investment out of the amount set aside for the reserve. It will be called **Debenture Redemption Reserve Investment**.

(7) Interest earned on DRR investments will be credited to profit and loss account.

(8) In **last year**, the Debenture Redemption Reserve Investments are **encashed** and the amount so obtained is used for the redemption of debentures.

(9) Any **profit or loss** made on the encashment of Debenture Redemption investments is also transferred to **Profit & Loss account**.

(10) The **balance** of Debenture Redemption Reserve is subsequently transferred to General Reserve.

INVESTMENT OF DEBENTURE REDEMPTION RESERVE (DRR) AMOUNT

Rule 18(7) of Companies (Share Capital and Debentures) Rules, 2014 prescribes the following conditions:

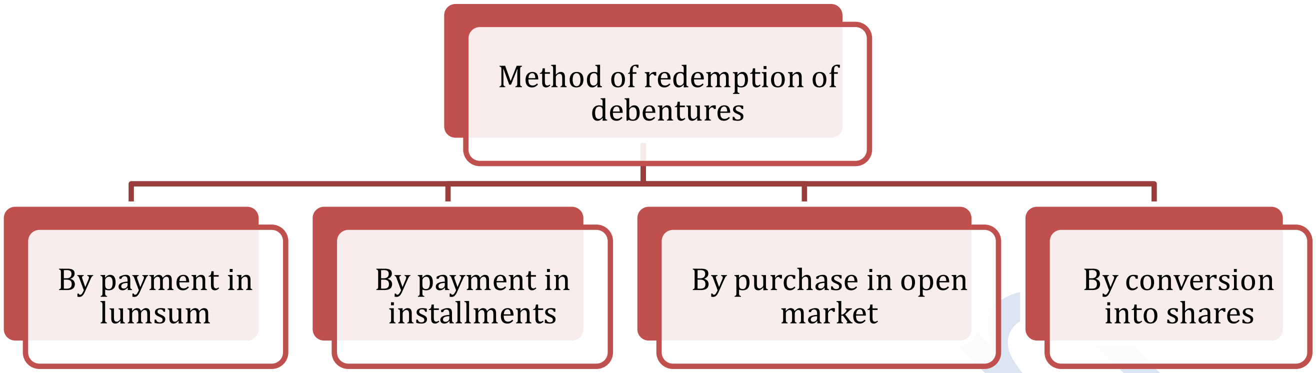
★ Every company required to create DRR should before the 30th day of April of each year, deposit or invest, as the case may be, a sum which should not be less than 15% of the amount of its debentures maturing during the year ending on the 31st day of March next following in any one or more of the following methods, namely:
  - in deposits with any scheduled bank, free from charge or lien;
  - in unencumbered securities of the Central Government or of any State Government;
  - in unencumbered securities mentioned in clauses (a) to (d) and (ee) of Section 20 of the Indian Trusts Act, 1882;
  - in unencumbered bonds issued by any other company which is notified under clause (f) of Section 20 of the Indian Trusts Act, 1882;

★ The amount deposited or invested, as the case may be, above should not be utilized for any purpose other than for the repayment of debentures maturing during the year referred to above, provided that the amount remaining deposited or invested, as the case may be, should not at any time fall below 15% of the amount of debentures maturing during the 31st day of March of that year.

★ Ministry of Corporate Affairs has made the following clarification on adequacy of Debenture Redemption Reserve (DRR):

		Pre August 16, 2019	Post August 16, 2019
1	For debentures issued by All India Financial Institutions (AIFIs) regulated by Reserve Bank of India and Banking Companies for both public as well as privately placed debentures	No DRR is required	No DRR is required
2	For other Financial Institutions (FIs) and NBFCs registered with RBI and for housing finance companies registered with National Housing Bank	25% of the value of outstanding debentures issued through public issue. No DRR is required in the case of privately placed debentures.	No DRR is required
3	For debentures issued by listed companies including manufacturing and infrastructure companies.	25% of the value of outstanding debentures issued through public issue. Also 25% DRR is required in the case of privately placed debentures by listed companies	No DRR is required (irrespective of public or Private Issue)
4	For unlisted companies issuing debentures on private placement basis,	DRR will be 25% of the value of outstanding debentures.	DRR will be 10% of the value of outstanding debentures

METHODS OF REDEMPTION



By payment in lumpsum
Under payment in lumpsum method, at maturity or at the expiry of a specified period of debenture the payment of entire debenture is made in one lot or even before the expiry of the specified period

By payment in Instalments
Under payment in installments method, the payment of specified portion of debenture is made in installments at specified intervals

ACCOUNTING FOR DEBENTURE REDEMPTION FUND AND INVESTMENT

Journal entries	
1. At the end of First Year	
For setting aside the fixed amount of profit for redemption Profit and Loss A/c To Debenture Redemption Reserve A/c (Being transfer of profits to Debenture redemption reserve A/c)	Dr.
For investing the amount set aside for redemption Debenture Redemption Reserve Investment A/c To Bank A/c (Being amount invested in DRR investment A/c)	Dr.
2. At the end of second year and subsequent years other than last year	
For receipt of interest on Debenture Redemption Reserve Investments	Dr.

Bank A/c To Interest on Debenture Redemption Reserve Investment A/c (Being interest on investment received)	
For transfer of Interest on Debenture Redemption Reserve Investment (DRRI) to profit and loss account. Interest on Debenture Redemption Reserve Investment A/c To Profit & Loss A/c (Being interest on investment transferred to P&L A/c)	Dr.
For setting aside the fixed amount of profit for redemption Profit and Loss A/c To Debenture Redemption Reserve A/c (Being transfer of profits to Debenture redemption reserve A/c)	Dr.
For investments of the amount set aside for redemption and the interest earned on DRRI Debenture Redemption Reserve Investment A/c To Bank A/c (Being amount invested in DRR investment A/c)	Dr.
3. **At the end of last year**	
For receipt of interest Bank A/c To Interest on Debenture Redemption Reserve Investment A/c (Being interest on investment received)	Dr.
For transfer of interest on Debenture Redemption Reserve Investment to Profit and loss account. Interest on Debenture Redemption Reserve Investment A/c Dr. To Profit and loss A/c	
For setting aside the fixed amount of profit for redemption Profit and Loss A/c Dr. To Debenture Redemption Reserve A/c	
For encashment of Debenture Redemption Reserve Investments Bank A/c Dr.	

To Debenture Redemption Reserve Investment, A/c
For the transfer of profit/loss on realization of Debenture Redemption Reserve Investments **(i)** In case of Profit Debenture Redemption Reserve Investment A/c Dr. To profit and loss A/c Or
(ii) In case of Loss Profit and loss A/c Dr To Debenture Redemption Reserve Investment, A/c
For amount due to debenture holders on redemption Debenture A/c Dr To Debenture holder's A/c
For payment to debenture holders Debenture holder's A/c Dr To Bank A/c
For transfer of balance in DRR to General Reserve Debenture Redemption Reserve A/c Dr. To General reserve A/c

ACCOUNTING FOR PURCHASE OF DEBENTURES IN THE OPEN MARKET

A company, if authorized by its Articles of Association, can buy its own debentures in the open market.
This can be categorized as follows:

For immediate cancellation

When the company cancels the debentures so purchased, it amounts to redemption of debentures. It means after cancellation; redemption is automatic, and these debentures cannot be reissued.

For investment in the form of own debentures

If the company purchases its debentures from open market and holds them for some time before cancellation, such debentures are known as own debentures. Own debentures are held by company as investment and may be resold till cancellation. After cancellation, the debentures are said to be redeemed and cannot be resold.

Accounting treatment for purchase of own debentures for immediate cancellation.

Journal entries	
On purchase and cancellation of debentures Debentures A/c (with the amount paid) To Bank A/c (Being debentures purchased in the open market and cancelled immediately)	 Dr.
If there is any difference between the nominal value of the debentures cancelled and the price paid for them, In case of profit Debenture A/c To Bank A/c To Profit on redemption of debentures A/c (Being debentures purchased in the open market for immediate cancellation and profit made on the same)	 Dr.
Transferring the above profit to Capital reserve A/c Profit on redemption of debentures A/c To Capital Reserve A/c	 Dr.
In case of loss Debenture A/c Loss on redemption A/c To Bank A/c (Being debentures purchased in the open market for immediate cancellation and Incurred loss on the same)	 Dr. Dr.
Transferring the above loss to Capital reserve A/c or P&L A/c or Securities premium A/c Profit and Loss A/c Or Securities Premium A/c Or Capital Reserve A/c To Loss on redemption A/c	 Dr. Dr. Dr.

ACCOUNTING FOR REDEMPTION BY CONVERSION

Journal entries	
When shares are issued at Par Debentures A/c To Share Capital A/c (Being debentures converted in ………… (no. of) Equity shares of Rs…. each)	 Dr.
When shares are issued at premium Debenture A/c To Share capital A/c To Securities premium A/c (Being debentures converted in ………… (no. of) Equity shares of Rs…. Each issued at a premium of Rs……each)	 Dr.

Illustrations

Illustration – 1

X Ltd. issued 1,00,000; 9% Debentures of Rs.50 each at a premium of 10% on 30th June, 2019 redeemable on 31st March 2021.The issue was fully subscribed. The Company decided to create DRR on 31st March,2020 and invest in Fixed Deposit Earnings interest @ 10% p.a. on 1st April 2020 to meet the legal requirement. Tax was deducted at source (TDS) by bank @ 10%.

Pass journal entries for issue and redemption of debentures along with interest on investment.

Illustration – 2

On January 1, Rama Ltd., had 500 Debentures of Rs.100 each outstanding in its books carrying interest at 6% per annum. DRR balance is standing in books at 12,500/-. In accordance with the powers in the deed, the directors acquired debentures from the open market for immediate cancellation as follows:

March 1	Rs.5,000 at 98.00/- (cum interest)
Aug. 1	Rs. 10,000 at 100.25/- (cum interest)
Dec. 15	Rs. 2,500 at 98.50/- (ex-interest)

Debenture interest is payable half-yearly, on 30th June and 31st Dec.

Show ledger accounts of Debenture and Debenture interest for the first year, ignoring income-tax.

Illustration – 3

The following balances appeared in the books of Paradise Ltd as on 1-4-20X1:

1. 12 % Debentures Rs. 7,50,000
2. Balance of DRR Rs. 1,00,000
3. DRR Investment 1,12,500 represented by 10% 1,125 Secured Bonds of the Government of India of Rs. 100 each.

Annual contribution to the DRR was made on 31st March every year. On 31-3-20X2, balance at bank was Rs. 7,50,000 before receipt of interest. The investment was realised at par for redemption of debentures at a premium of 10% on the above date.

You are required to prepare the following accounts for the year ended 31st March, 20X2:

1. Debentures Account
2. DRR Account
3. DRR Investment Account
4. Bank Account

Debenture Holders Account.

Illustration - 4

Sencom Limited issued Rs.1,50,000 5% Debentures on 30th September Year 0 on which interest is payable half yearly on 31st March and 30th September. The Company has power to purchase debentures in open market for cancellation thereof.

The following purchases were made during the year ended 31st December Year 2 and the cancellation were made on the same date. On 31st December Year 1, balance in the DRR of the Company was Rs.25,000 and investments made for the purpose of redemption were Rs.20,000.

The purchase details are:

- 1st March Year 2 – Rs.25,000 nominal value purchased for Rs.24,725 ex-interest.
- 1st September Year 2– Rs.20,000 nominal value purchased for Rs.20,125 cum-interest.

You are required to draw up the following accounts up to the date of cancellation:

(i) Debentures Account and
(ii) Own Debenture (Investment) Account.

Ignore Taxation.

Illustration - 5

Deleted

Illustration - 6

The Summarized Balance Sheet of BEE Co. Ltd. as on 31st March, 20X1 is as under:

Liabilities	Amount (Rs.)	Assets	Amount (Rs.)
Share Capital: Authorized: 30,000 Equity Shares of Rs. 10 each	_ 3,00,000	Freehold property	1,15,000
		Stock	1,35,000
		Trade receivables	75,000
Issued and Subscribed: 20,000 Equity Shares of Rs. 10 each fully paid	2,00,000	Cash	30,000

		Balance at Bank	2,00,000
Profit and Loss Account	1,20,000		
12% Debentures	1,20,000		
Trade payables	1,15,000		
	5,55,000		**5,55,000**

At the Annual General Meeting, it was resolved:

1. To give existing shareholders the option to purchase one Rs. 10 shares at Rs. 15 for every four shares (held prior to the bonus distribution), this option being taken up by all shareholders.
2. To issue one bonus share for every five shares held.
3. To repay the debentures at a premium of 3%.

Give the necessary journal entries and the company's Balance Sheet after these transactions are completed.

Illustration – 7

The summarised Balance Sheet of Convertible Limited, as on 30th June, 20X1, stood as follows:

Particulars	Amount (Rs.)
Liabilities:	
Share Capital: 5,00,000 equity shares of Rs. 10 each fully paid	50,00,000
General Reserve	75,00,000
Profit And loss A/c	10,00,000
Debenture Redemption Reserve	25,00,000
13.5% Convertible Debentures, 1,00,000 Debentures of Rs. 100 each	1,00,00,000
Other loans	65,00,000
Current Liabilities and Provisions	1,25,00,000
	4,50,00,000

The Debentures are due for redemption on 1st July, 20X1. The terms of issue of debentures provided that they were redeemable at a premium of 5% and conferred option to the debenture holders to convert 20% of their holdings into equity shares at a predetermined price of Rs.15.75 per share and the payment in cash.

Assuming that:

1. except for 100 debenture holders holding totally 25,000 debentures, the rest of them exercised the option for maximum conversion.
2. the investments were realised at par on sale; and
3. all the transactions are put through, without any lag, on 1st July, 20X1.

Redraft the balance sheet of the company as on 1st July, 20X1 after giving effect to the redemption. Show your calculations in respect of the number of equity shares to be allotted and the necessary cash payment.

Illustration 8

The following balances appeared in the books of a company, which is an unlisted company other than All India Financial Institution , Banking Company, NBFC and HFC, as on 31st December of Year 1:

- 6% Mortgage 10,000 debentures of Rs.100 each;
- Debenture Redemption Reserve (for redemption of debentures) Rs.2,00,000;
- Investments in deposits with a scheduled bank free from any charge or lien Rs.1,50,000 at interest of 4% p.a. receivable on 31st December every year.
- Bank Balance with the company is Rs.9,00,000.
- The Interest on debentures has been paid up to 31st December of Year 1.

On 28th February of Year 2, the investments were realised at par and the debentures were paid off at Rs.101, together with accrued interest.

Write up the concerned ledger accounts (excluding bank transactions). Ignore taxation.

Illustration 9

A Company has issued 20,000 13% debentures of Rs.100 each on 1st April 20X1. The debentures are due for redemption on 1st July 20X2.

The terms of issue of debentures provided that they were redeemable at a premium of 5% and also conferred option to debenture holders to convert 20% of their holding into equity shares (Nominal value Rs.10) at a price of Rs.15 per share. Debenture holders holding 2,500 debentures did not exercise the option.

Calculate the number of equity shares to be allotted to the debenture holders exercising the option to the maximum

Illustration 10

Libra Limited (a listed company) recently made a public issue in respect of which the following information is available:

(a) No. of partly convertible debentures issued- 2,00,000; face value and issue price - Rs. 100 per debenture.

(b) Convertible portion per debenture- 60%, date of conversion- on expiry of 6 months from the date of closing of issue.

(c) Date of closure of subscription lists- 1.5.20X1, date of allotment- 1.6.20X1, rate of interest on debenture- 15% payable from the date of allotment, value of equity share for the purpose of conversion- Rs. 60 (Face Value Rs. 10).

(d) Underwriting Commission- 2%.

(e) No. of debentures applied for- 1,50,000.

(f) Interest payable on debentures half-yearly on 30th September and 31st March.

Write relevant journal entries for all transactions arising out of the above during the year ended 31st March, 20X2 (including cash and bank entries).

INVESTMENT ACCOUNTS

INTRODUCTION

★ **Investment -** Assets held for earning income by way of dividend, interest and rental, for capital appreciation or other benefits.
★ Assets held as stock in trade are not investments
★ Examples of investments

Income	Investment
Interest	FDs and Debentures, Debt instruments, Bonds
Dividends	Shares
Rentals	Property
Capital appreciation (Sale value much higher than the cost)	All the above + Gold

★ Accounting is done as per AS-13 'Accounting for investments' which deals with the accounting in a financial statement and also the disclosure requirements.
★ Exclusions – AS 13 does not apply to

3. Income aspect from such investment (AS-9)
4. Operating and finance lease (AS-19)
5. Stock in trade (AS-2)
6. Investment in retirement benefit plans, LIC policies (As-15)
7. Mutual funds, Venture capital funds, Banks and Public financial Institutions

DEFINITIONS

Fair value - 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-The amount obtainable from the sale of an investment in an open market, net of expenses necessarily to be incurred on or before disposal.

Fixed income Bearing Securities: These refer to securities having fixed return of income. Investment in Government securities or debentures comes under this category.

Variable Income Bearing Securities: These refer to securities having variable return of income. Investment in equity shares comes under this category.

Carrying amount – Subsequent recognition on Balance sheet date.

CLASSIFICATION OF INVESTMENTS

Short term(Current investment)

- Intended to be held for not more than 1 year from the date on which such invesment is made - Readily realisable
- Initial recognition - At cost
- Subsequent recognition (carrying amount) - Lower of cost or fair value
- Any reduction to fair value and any reversals of such reductions are included in the statement of profit and loss.
- It should not be on overall (global) basis. However it can be category wise.

Long term Investment

- Held for more than 1 year
- Initial recognition - At cost
- Subsequent recognition (carrying amount) Cost less provision for permanent diminution
- In case of permanent decline the carrying amount is reduced to realisable value. The loss due to permanent decline should be charged to P&L. If subsequently there is permanent markup the the loss charged to P&L above is reversed

INVESTMENT ACCOUNT

A separate Investment Account should be made for each investment made (i.e. for each scrip purchased).

Proforma Investment Account

In the books of ________________

For the period from ______________________ to ___________________

Name of the scrip __________________

Date	Particulars	Nominal Value	Interest	Cost	Date	Particulars	Nominal Value	Interest	Cost

Note:

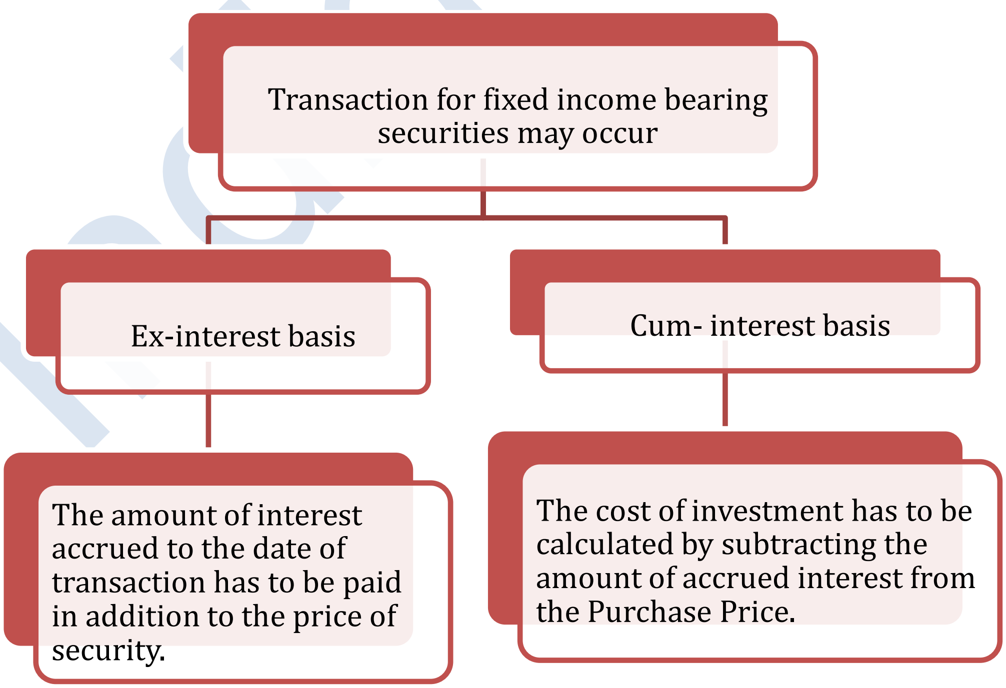
1. The 3rd Column (& 8th column) can contain either number of shares or nominal value of shares
2. Right shares renounced are not part of investment account. They are directly shown in the P&L.
3. Interest amount is always calculated with respect to nominal value (par value/ nominal value)

COST OF INVESTMENTS

Scenarios	Cost
If investment is acquired	Acquisition price + brokerage + duties + any other fees
Investment is acquired by issue of shares or other securities	Fair value of securities issued Note - The fair value may not necessarily be equal to the nominal or par value of the securities issued.
Investment is acquired in exchange of or part exchange of any other asset	Fair value of asset given up OR Fair value of investment received (whichever is clearly evident)
Investment is acquired cum-interest	Interest portion is deducted from cost. A part of purchase price is related to the interest accrued from the date of the last interest paid to the date of transaction

Investment is acquired ex-interest	Cost = Acquisition price. As interest is not part of the price. However, we need to calculate the interest and pay it along with the investment.
Bonus shares	Cost = Nil. Only number of shares increases
Right Shares - When rights are subscribed	Cost = Rights value This is added to the carrying amount of investment
Right Shares - If rights are sold in the market and are not subscribed	The sale proceeds are credited to P&L
Note - 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.	
Investment properties - in case of co-operative society	cost of property + cost of shares (if shares are necessary to acquire the investment property)

FIXED INCOME BEARING SECURITIES



Journal entries	
When investment is purchased	
Investment A/c	Dr.
Interest Accrued A/c	Dr.
To Bank A/c	

Note:

1. In case the transaction is ex-interest basis, the Investment A/c is debited with the price settled on ex-interest basis.

2. In case the transaction is cum-interest basis, the Investment A/c is debited with the price settled on cum-interest basis less interest accrued.

3. Interest accrued is calculated from the previous due date to date of transaction.

4. When the interest amount is actually received, it is entered in the Income Column credit side. The net effect of these entries will be that the amount credited to the income will be only the interest arising between the date of purchase and the one on which its next fall's due.

5. In case the quotation does not specify whether it is ex-interest or cum- interest, the same will be treated as ex-interest quotation as per the general practice.

VARIABLE INCOME BEARING SECURITIES

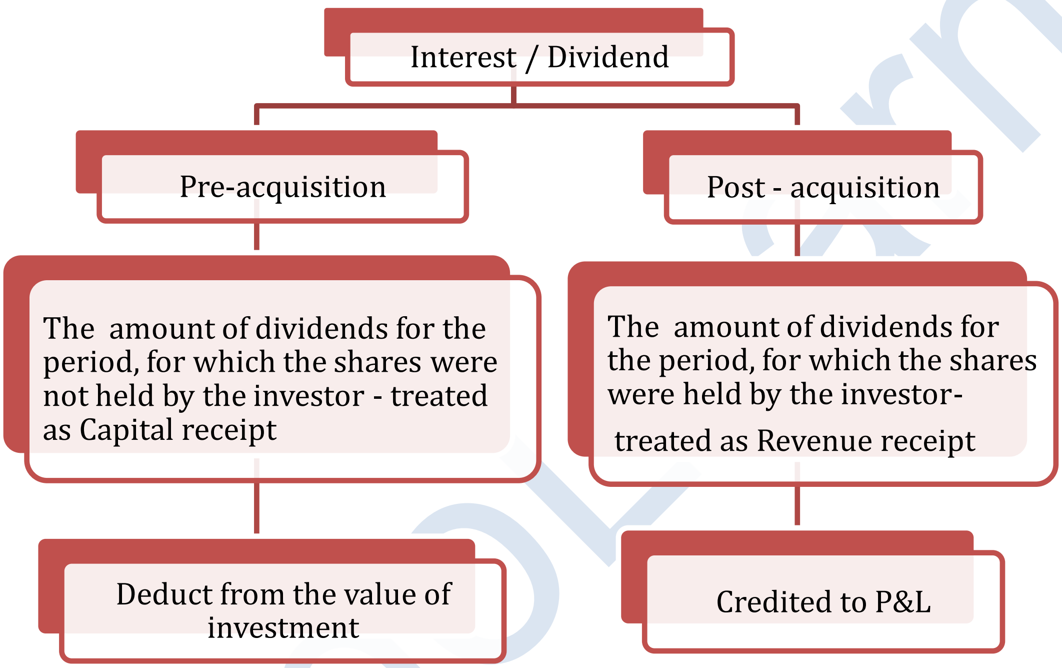
The following points should be noted with respect to investment in equity shares:

- Dividends from investments in shares are not recognized in the statement of profit and loss until a right to receive payment is established;
- The amount of dividend accruing between the date of last dividend payment and the date of purchase cannot be immediately ascertained.

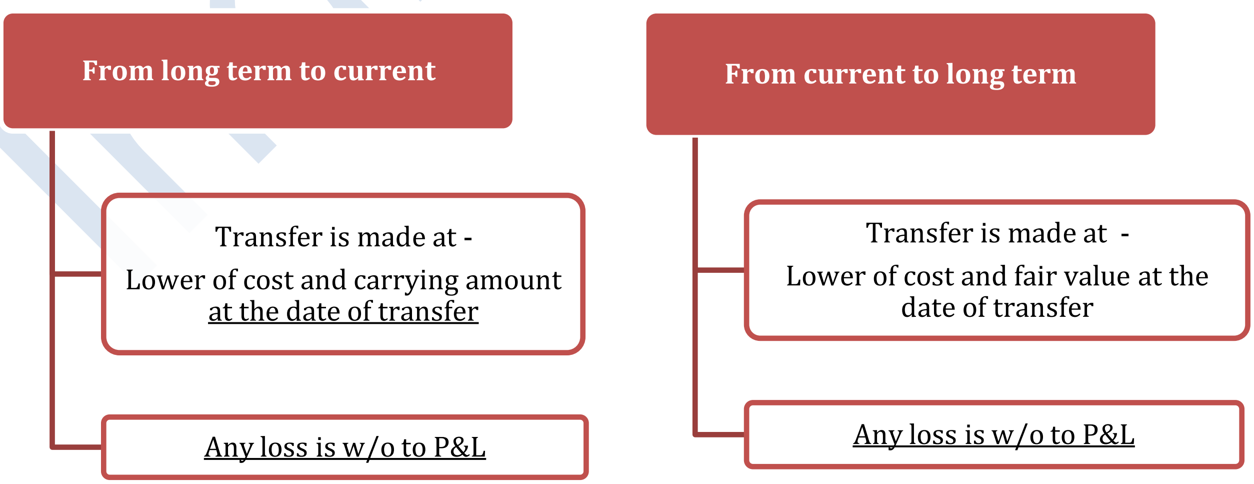
Journal entries
When investment is purchased Investment A/c (with the entire purchase price) Dr. To Bank A/c
The adjustment with respect to dividend is made when the dividend is received as under Bank A/c Dr. To Investment A/c (with amount of pre-acquisition dividend) To Investment A/c (With amount of post-acquisition dividend)
Note: 1. The amount of pre-acquisition dividend will appear in Capital Column of 'Investment A/c'. 2. The amount of post-acquisition dividend will appear in Income Column of 'Investment A/c' 3. When dividends on equity shares are declared from pre-acquisition profits, the amount of such dividend received by the investor is entered on the credit side

in the capital column, so as to reduce the acquisition cost.

4. If it is difficult to make an allocation between pre and post-acquisition periods except on an arbitrary basis, the cost of investment is normally reduced by dividends receivable, only if they clearly represent recovery of part of the cost.



RECLASSIFICATION OF ASSETS



DISPOSAL OF INVESTMENT

- **Dispose fully**
  - Difference between the Carrying amount and Net sale proceeds is accounted taken to **P&L account**
- **Dispose partly**
  - The **average carrying amount** proportionate to the part of investment disposed is considered.

Net sale proceeds = Sale proceeds – expenses on sale.

Disposal of investment

- Fixed income bearing securities
  - Transaction is on 'Cum-interest basis'
    - The amount of accrued interest * is credited in the income column and only the sale proceeds, net of accrued interest is credited in the capital column of investment account.
  - Transaction is on 'Ex-interest' basis
    - Entire sale proceeds is credited in the capital column and the amount of accrued interest , separately received from the buyer will be taken to the credit side of the income column of investment account
- Variable income bearing securities
  - The entire amount of sale proceeds should be credited in the capital column of investment account, unless the amount of accrued dividend can be specifically established.
- Securities held as stock in trade
  - The cost of stocks disposed of is determined by applying an appropriate cost formula (e.g., first-in, first-out (FIFO), average cost, etc.) as specified in AS 2, Valuation of Inventories.

Accrued interest is computed from the date of last payment to the date of sale.

DISCLOSURE

The following disclosures in financial statements in relation to investments are appropriate:

a. The **accounting policies** followed for valuation of investments.
b. The **amounts included in profit and loss statement** for:
    - 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.
    - Profits and losses on disposal of current investments and changes in carrying amount of such investments.
    - 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.

Illustrations

Illustration 1

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 cum-interest prices, also paying brokerage @ 1% of cum-interest amount of the purchase. On 1st March, 20X3 the firm sold all these debentures at Rs. 106 cum-interest prices, again paying brokerage @ 1 % of cum-interest amount. Prepare Investment Account in the books of M/s. Bull & Bear for the period 1st December, 20X2 to 1st March, 20X3.

Illustration 2

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.

Illustration 3

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.

Illustration 4

On 01-04-20X1, Mr. T. Shekharan purchased 5,000 equity shares of Rs.100 each in V Ltd. @ Rs.120 each from a broker, who charged 2% brokerage. He incurred 50 paisa per Rs.100 as cost of shares transfer stamps. On 31-01-20X2 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 31-03-20X2, Mr. T. Shekharan sold bonus shares to a broker, who charged 2% brokerage.

Show the Investment Account in the books of T. Shekharan, who held the shares as Current Assets and closing value of investments shall be made at cost or market value whichever is lower.

Illustration 5

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.

Illustration 6

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.

<u>Dividends:</u> 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 31.12.20X1 and shares are valued at average cost.

Illustration 7

On 1st January 20X1, Singh had 20,000 equity shares in X Ltd. Nominal value of the shares was Rs.10 each but their book value was Rs.16 per share. On 1st June 20X1, Singh purchased 5,000 more equity shares in the company at a premium of Rs.4 per share.

On 30th June, 20X1, the directors of X Ltd. announced a bonus and rights issue. Bonus was declared at the rate of one equity share for every five shares held and these shares were received on 2nd August, 20X1.

The terms of the rights issue were:

a. Rights shares to be issued to the existing holders on 10th August, 20X1.
b. Rights issue would entitle the holders to subscribe to additional equity shares in the Company at the rate of one share per every three held at Rs.15 per share-the whole sum being payable by 30th September, 20X1.
c. Existing shareholders were entitled to transfer their rights to outsiders, either wholly or in part.
d. Singh exercised his option under the issue for 50% of his entitlements and the balance of rights he sold to Ananth for a consideration of Rs.1.50 per share.
e. Dividends for the year ended 31st March, 20X1, at the rate of 15% were declared by the Company and received by Singh on 20th October, 20X1.
f. On 1st November, 20X1, Singh sold 20,000 equity shares at a premium of Rs.3 per share.

The market price of share on 31-12-20X1 was Rs.14. Show the Investment Account as it would appear in Singh's books on 31-12-20X1 and the value of shares held on that date.

Illustration 8

A Limited purchased 5,000 equity shares (nominal value Rs.100 each) of Allianz Limited for Rs.105 each on 1st April, 20X1. The shares were quoted cum dividend. On 15th May, 20X1, Allianz Limited declared & paid dividend of 2% for year ended 31st March, 20X1.

On 30th June, 20X1 Allianz Limited issued bonus shares in ratio of 1:5. On 1st October, 20X1 Allianz Limited issued rights share in the ratio of 1:12 @ 45 per share. A Limited subscribed to half of the rights issue and the balance was sold at Rs.5 per right entitlement.

The company declared interim dividend of 1% on 30th November, 20X1. Right shares were not entitled to dividend. The company sold 3,000 shares on 31st December, 20X1 at Rs.95 per share. The company A Ltd. incurred 2% as brokerage while buying and selling shares.

You are required to prepare Investment Account in books of A Ltd for the year ended 31st March, 20X2.

Illustration 9

The following transactions of Nidhi took place during the year ended 31st March 20X2:

Date	Transactions
1st April	Purchased Rs.12,00,000, 8% bonds at Rs.80.50 cum-interest. Interest is payable on 1st November and 1st May.
12th April	Purchased 1,00,000 equity shares of Rs.10 each in X Ltd. for Rs.40,00,000
1st May	Received half-year's interest on 8% bonds.
15th May	X Ltd. made a bonus issue of three equity shares for every two held. Nidhi sold 1,25,000 bonus shares for Rs.20 each.
1st October	Sold Rs.3,00,000, 8% bonds at Rs.81 ex-interest.
1st November	Received half-year's bond interest.
1st December	Received 18% dividend on equity shares in X Ltd.

Prepare the relevant investment account in the books of Nidhi for the year ended 31st March, 20X2.

Illustration - 10

Smart Investments made the following investments in the year 20X1-X2:

12% State Government Bonds having nominal value Rs.100

01.04.20X1	Opening Balance (1200 bonds) book value of Rs.126,000
02.05.20X1	Purchased 2,000 bonds @ Rs.100 cum interest
30.09.20X1	Sold 1,500 bonds at Rs.105 ex interest

Interest on the bonds is received on 30th June and 31st December each year.

Equity Shares of X Ltd.	
15.04.20X1	Purchased 5,000 equity shares @ Rs.200 on cum right basis Brokerage of 1% was paid in addition (Nominal Value of shares Rs.10)
03.06.20X1	The company announced a bonus issue of 2 shares for every 5 shares held.

16.08.20X1	The company made a rights issue of 1 share for every 7 shares held at Rs.250 per share. The entire money was payable by 31.08.20X1.
22.8.20X1	Rights to the extent of 20% was sold @ Rs.60. The remaining rights were subscribed.
02.09.20X1	Dividend @ 15% for the year ended 31.03.20X1 was received on 16.09.20X1.
15.12.20X1	Sold 3,000 shares @ Rs.300. Brokerage of 1% was incurred extra.
15.01.20X2	Received interim dividend @ 10% for the year 20X1 –X2
31.03.20X2	The shares were quoted in the stock exchange @ Rs.220

Prepare Investment Accounts in the books of Smart Investments. Assume that the average cost method is followed.

Illustration - 11 - RTP Nov 2019

A Pvt. Ltd. follows the calendar year for accounting purposes. The company purchased 5,000 (nos.) 13.5% Convertible Debentures of Face Value of Rs. 100 each of P Ltd. on 1st May2018 @ Rs.105 on cum interest basis.

The interest on these instruments is payable on 31st March & 30th September respectively. On August 1st, 2018 the company again purchased 2,500 of such debentures @ Rs. 102.50 each on cum interest basis.

On 1st October 2018 the company sold 2,000 Debentures @ Rs. 103 each. On 31st December 2018 the company received 10,000 equity shares of Rs. 10 each in P Ltd. on conversion of 20% of its holdings. Interest for 3 months on converted debentures was also received on 31.12.2018.

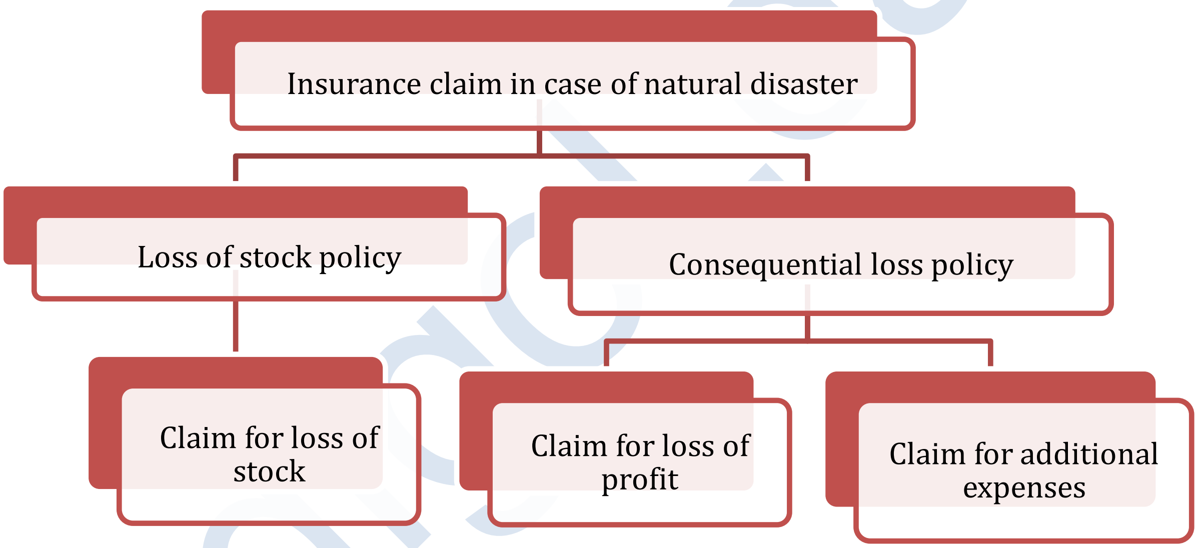
The market value of the debentures and equity shares as at the close of the year were Rs. 106 and Rs. 9 respectively. Prepare the Debenture Investment Account & Equity Shares Investment Account in the books of A Pvt. Ltd. for the year 2018 on Average Cost Basis.

INSURANCE CLAIMS FOR LOSS OF STOCK AND LOSS OF PROFIT

INTRODUCTION

★ Business enterprises get insured against the loss of stock on the happening of certain events such as fire, flood, theft, earthquake etc.

★ Insurance being a contract of indemnity, the claim for loss is restricted to the actual loss of assets. Sometimes an enterprise also gets itself insured against consequential loss of profit due to decreased turnover, increased expenses etc.



MEANING OF FIRE

For purposes of insurance, fire means:

1. Fire (whether resulting from explosion or otherwise) not occasioned or happening through:

(a) Its own spontaneous fomentation or heating or it undergoing any process involving the application of heat;

(b) Earthquake, subterranean fire, riot, civil commotion, war, invasion act of foreign enemy, hostilities (whether war be declared or not), civil war, rebellion, revolution, insurrection, military or usurped power.

2. Lightning

3. Explosion, not occasioned or happening through any of the perils in 1 (a) above

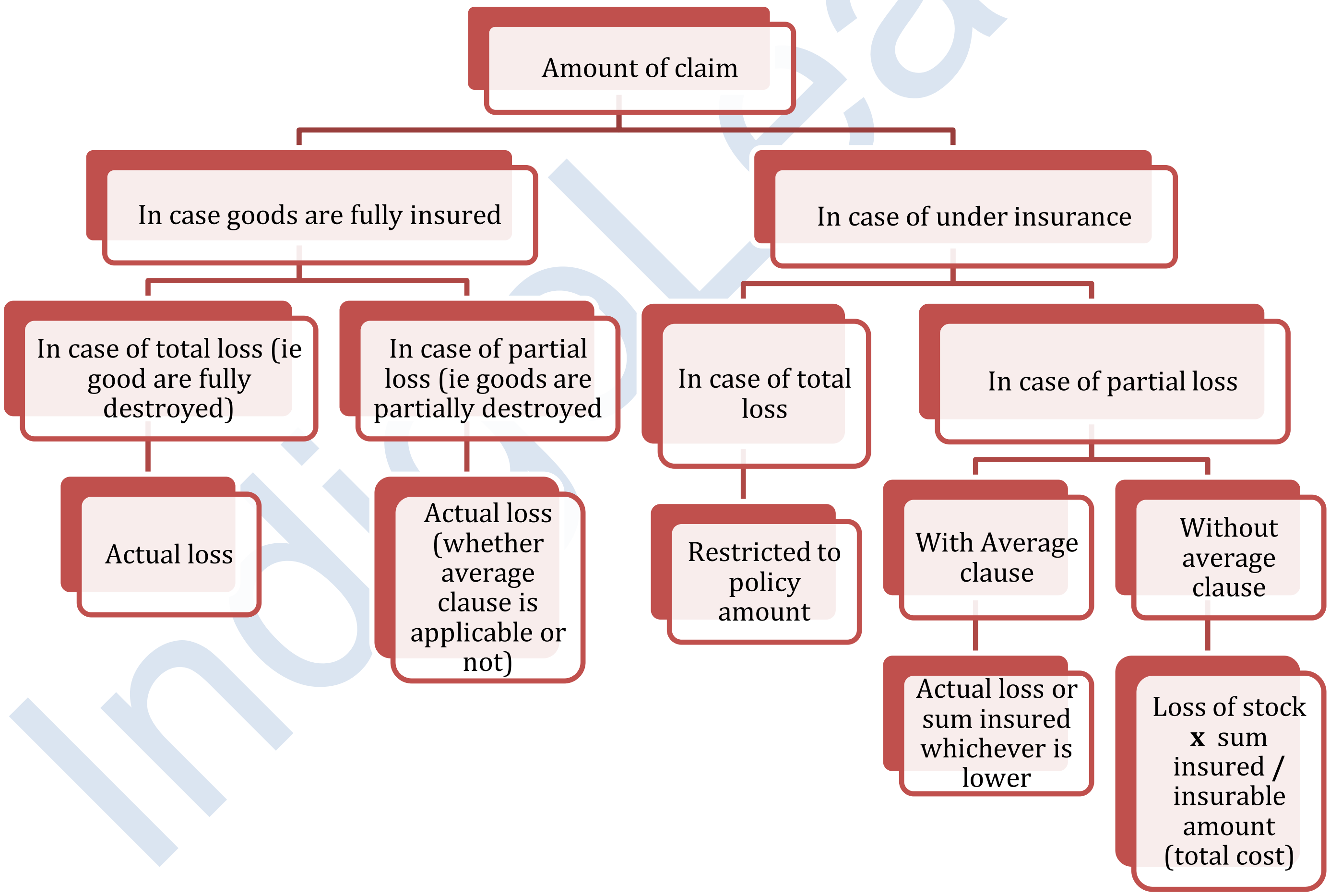
(i) Of boilers used for domestic purposes only;

(ii) Of any other boilers or economizers on the premises;

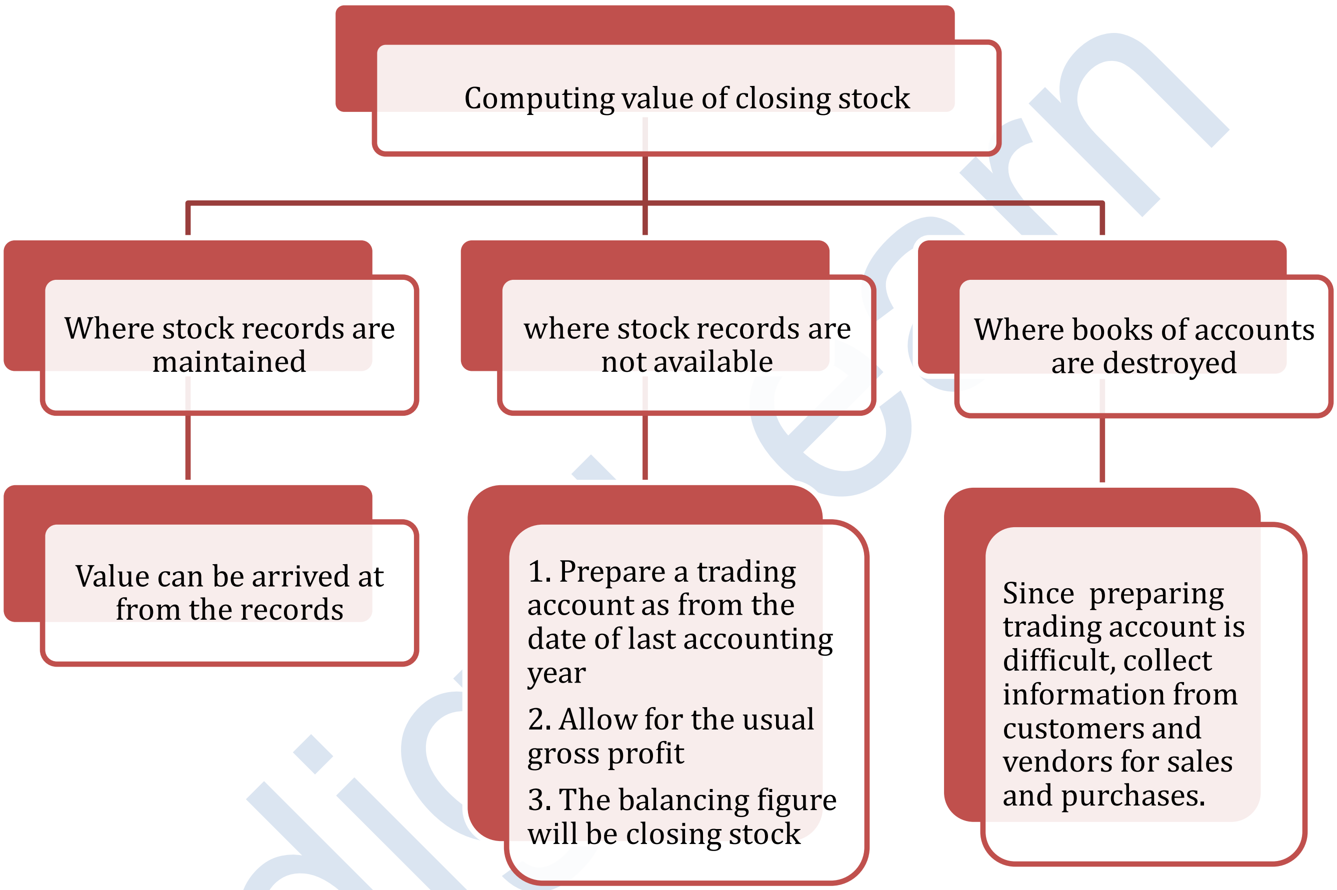
(iii) In a building not being any part of any gas works or gas for domestic purposes or used for lighting or heating the building.

The policy of insurance can be made to cover any of the excepted perils by agreement and payment of extra premium, if any. Damage may also be covered if caused by storm or tempest, flood, escape of water, impact and break down of machinery, etc., again by agreement with the insurer.

CLAIM FOR LOSS OF STOCK



COMPUTING VALUE OF STOCK ON THE DATE OF FIRE

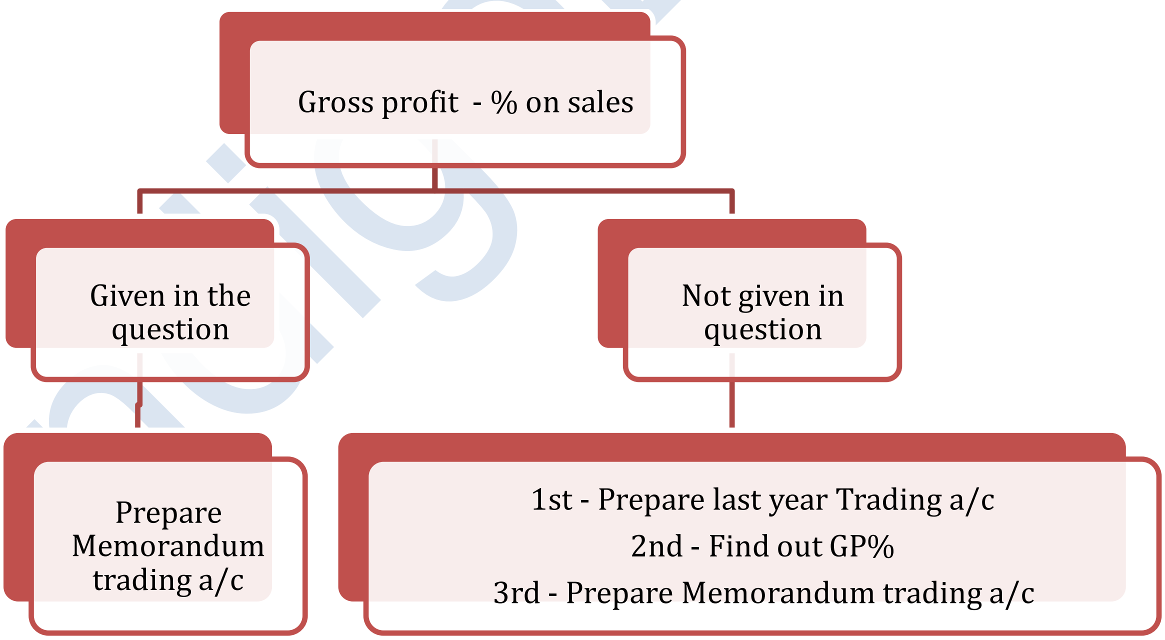


1. In determining the amount of the claim, credit is given for damaged and salvaged stock.
2. Frequently salvaged stock can be made saleable after it is reconditioned. In that case, the cost of such stock must be credited to the Trading Account and debited to a salvaged stock account. The expenses on reconditioning must be debited and the sales credited to this account, the final balance being transferred to the Profit & Loss Account.

Computation of loss of stock	
Value of stock on the date of fire	xxx
Less - Value of salvaged stock	xxx
Amount of loss of stock	xxx

Amount transferred to P&L A/c	
Value of Salvages stock	xxx
Add - Expenses on re-conditioning	xxx
Less - sales	xxx
Profit / loss transferred to P&L A/c	xxx

Performa Memorandum trading account					
Date	Particulars	Amount	Date	Particulars	Amount
	Opening stock	xxx		Sales	xxx
	Purchases	xxx		Closing stock on date of fire (Balancing Figure)	xxx
	Gross profit	xxx			
		xxx			Xxx



ADJUSTMENTS TO BE MADE IN TRADING ACCOUNT

In the given scenarios, adjustments have to be made to the trading account in order to arrive at the correct gross profit ratio.

1. Undervaluation / overvaluation of closing stock of last year
   Add back or reduce the value of Closing stock.

2. Change in price level of stocks (either +ve or -ve)
   i. If current year price level has changed over last year then 1st adjust every component of current year's Memorandum trading A/c to ensure it is at same pricing level as of last year.
   ii. Apply last year's GP ratio and arrive at the Closing stock
   iii. Adjust the closing stock with the price level change

3. Abnormal stock in the last year -
   i. Abnormal means anything which cannot be sold at normal GP ratio
   ii. If abnormal stock is in Closing stock – subtract the value at realizable price
   iii. If abnormal stock is in sales – subtract the value at selling price Correspondingly
   iv. Remove abnormal stock from opening stock / purchases in the current year – subtract the value at cost price.

CLAIM FOR LOSS OF PROFIT

★ When a fire occurs, apart from the direct loss on account of stock or other assets destroyed, there is also a consequential loss because, for some time, the business is disorganized or has to be discontinued, and during that period, the standing expenses of the business like rent, salaries etc. continue.

★ Moreover, there is loss of profit which the business would have earned during the period. This loss can be insured against by a "Loss of Profit or "Consequential Loss" policy.

★ There must be a separate policy in respect of the consequential loss, but claim will be admitted in respect of the policy only when the claim on account of fire is also admitted under other policies.

★ The Loss of Profit Policy normally covers the following items:
   - Loss of net profit
   - Any increase in the cost of working, e.g., renting of temporary premises etc.

★ A claim for loss of profit cannot arise if the claim for loss of property as a result of the fire is not admitted.

★ To measure the loss suffered by a firm due to fire, it is necessary to setup some standard expressed in such units to represent the volume of work. A comparison between the amount of the standard before and after the fire will give a reliable indication of the loss of profit. The most satisfactory unit of measuring profit is turnover.

★ Insurance does not cover electrical installations and the like

DEFINITIONS OF IMPORTANT TERMS

Net Profit - The net trading profit (exclusive of all capital receipts and accretion and all outlay properly chargeable to capital) resulting from the business after due provision has been made for all standing and other charges including depreciation.

Insured Standing Charges – All fixed expenses like Interest on Debentures, Mortgage Loans and Bank Overdrafts, Rent, Rates and Taxes (other than taxes which form part of net profit), Salaries of Permanent Staff and Wages to Skilled Employees, Boarding and Lodging of resident Directors and/or Manager, Directors' Fees, Unspecific Standing Charges [not exceeding 5% of the amount recoverable in respect of Specific Standing Charges].

Insured standing charges may include additional items, by agreement with the insurer.

Rate of Gross Profit - The rate of Gross Profit earned on turnover during the financial year immediately before the date of damage.

Annual Turnover – The turnover during the twelve months immediately before the date of damage.

Indemnity Period - The period beginning with the occurrence of the damage and ending not later than twelve months. i.e... Period after the fire when the business is disrupted cannot exceed 12 months.

Depending upon the nature of business, the indemnity period may extend beyond 12 months (it may be as long as 6 years). Indemnity period shall not be confused with the period of insurance which cannot be more than one year.

The insurance for Loss of Profit is limited to loss of gross profit due to

(i) Reduction in turnover, and
(ii) Increase in the cost of working.

Standard Turnover: The turnover during that period (in the twelve months immediately before the date of damage) which corresponds with the Indemnity Period.

Standard TO should be adjusted for any upward or downward trend

Short sales - Sales that could not be made due to fire

Amount of Indemnity Payable	
Gross Profit Lost	xxx
(+) Claim for increased cost of working Capital	xxx
(-) Saving in Insured standing Charges.	xxx
	xxx

COMPUTATION OF AMOUNT OF CLAIM FOR LOSS OF PROFIT

Step 1 - Reduction in Turnover (Short sales)		
Standard Turnover		xxx
+ / - Adjustment for trend		xxx
(-) Actual turnover during Indemnity period		xxx
Short sales		xxx
GP on short sales		xxx
Step 2 - Additional expenses - Lower of the following		
i. Actual expenses	xx	
ii. GP on sales generated by increase cost of working	xx	
iii. Additional expenses **x** $\frac{\text{GP on adjusted Annual Turnover}}{\text{GP on adjusted Annual Turnover + uninsured standing charges}}$	xx	
		xx
Step 3 - Reduce savings in additional standing charges		(xx)
Amount of claim before average clause		xxx
Step 4 - Average clause		
Amount of claim = Amount of claim (per step 3) **x** $\frac{\text{Policy amount}}{\text{GP on Annual Turnover}}$		xxx

Note:

1. Rate of Gross profit (GP) for last year = $\frac{\text{Net proft+Insured standing charges}}{\text{Turnover for last financial year}}$ **x** 100

2. Gross Profit (GP)

   = NP + Insured standing charges **OR**

$= \text{Insured standing charges} - [\text{ net trading loss (if any) X } \frac{\text{Insured statnding charges}}{\text{Total standing charges}}$

3. Net profit means profit before income tax based on profits.

Illustrations

Illustration - 1

From the following information, ascertain the value of stock as on 31st March, 20X2:

	Rs.
Stock as on 01-04-20X1	28,500
Purchases	1,52,500
Manufacturing Expenses	30,000
Selling Expenses	12,100
Administration Expenses	6,000
Financial Expenses	4,300
Sales	2,49,000

At the time of valuing stock as on 31st March, 20X1, a sum of Rs. 3,500 was written off on a particular item, which was originally purchased for Rs. 10,000 and was sold during the year for Rs. 9,000. Barring the transaction relating to this item, the gross profit earned during the year was 20% on sales.

Illustration – 2

On 20th October, 20X1, the godown and business premises of Aman Ltd. were affected by fire. From the salvaged accounting records, the following information is available:

	Rs.
Stock of goods @ 10% lower than cost as on 31st March, 20X1	2,16,000
Purchases less returns (1.4.20X1 to 20.10.20X1)	2,80,000
Sales less returns (1.4.20X1 to 20.10.20X1)	6,20,000

Additional information:

(1) Sales up to 20th October, 20X1 includes Rs. 80,000 for which goods had not been dispatched.

(2) Purchases up to 20th October, 20X1 did not include Rs. 40,000 for which purchase invoices had not been received from suppliers, though goods have been received in Godown.

(3) Past records show the gross profit rate of 25%.

(4) The value of goods salvaged from fire Rs. 31,000.

(5) Aman Ltd. has insured their stock for Rs. 1,00,000.

Compute the amount of claim to be lodged to the insurance company.

Illustration – 3

On 2.6.2019 the stock of Mr. Black was destroyed by fire. However, following particulars were furnished from the records saved:

Particulars	Amount (Rs.)
Stock at cost on 1.4.2018	1,35,000
Stock at 90% of cost on 31.3.2019	1,62,000
Purchases for the year ended 31.3.2019	6,45,000
Sales for the year ended 31.3.2019	9,00,000
Purchases from 1.4.2019 to 2.6.2019	2,25,000
Sales from 1.4.2019 to 2.6.2019	4,80,000

- Sales up to 2.6.2019 includes Rs. 75,000 being the goods not dispatched to the customers. The sales (invoice) price is Rs. 75,000.
- Purchases up to 2.6.2019 includes a machinery acquired for Rs. 15,000.
- Purchases up to 2.6.2019 does not include goods worth Rs. 30,000 received from suppliers, as invoice not received up to the date of fire. These goods have remained in the godown at the time of fire.
- The insurance policy is for Rs. 1,20,000 and it is subject to average clause. Ascertain the amount of claim for loss of stock.

Illustration-4

On 12th June, 20X2 fire occurred in the premises of N.R. Patel, a paper merchant. Most of the stocks were destroyed, cost of stock salvaged being Rs. 11,200. In addition, some stock was salvaged in a damaged condition and its value in that condition was agreed at Rs. 10,500. From the books of account, the following particulars were available:

- His stock at the close of account on December 31, 20X1 was valued at Rs. 83,500.
- His purchases from 1-1-20X2 to 12-6-20X2 amounted to Rs. 1,12,000 and his sales during that period amounted to Rs. 1,54,000.
- On the basis of his accounts for the past three years it appears that he earns on an average a gross profit of 30% of sales.
- Patel has insured his stock for Rs. R 60,000.

Compute the amount of the claim.

Illustration - 5

On 1st April, 20X2 the stock of Shri Ramesh was destroyed by fire, but sufficient records were saved from which following particulars were ascertained:

Particulars	Amount (Rs.)
Stock at cost-1st January, 20X1	73,500
Stock at cost-31st December, 20X1	79,600

Purchases-year ended 31st December,20X1	3,98,000
Sales-year ended 31st December, 20X1	4,87,000
Purchases-1-1-201X2 to 31-3-20X2	1,62,000
Sales-1-1-20X2 to 31-3-20X2	2,31,200

- In valuing the stock for the Balance Sheet at 31st December, 20X1 Rs. 2,300 had been written off on certain stock which was a poor selling line having the cost Rs. 6,900.
- A portion of these goods were sold in March, 20X2 at loss of Rs. 250 on original cost of Rs. 3,450. The remainder of this stock was now estimated to be worth its original cost.
- Subject to the above exception, gross profit had remained at a uniform rate throughout the year.
- The value of stock salvaged was Rs. 5,800. The policy was for Rs. 50,000 and was subject to the average clause. Work out the amount of the claim of loss by fire.

Illustration – 6

On 30th March, 20X2 fire occurred in the premises of M/s Suraj Brothers. The concern had taken an insurance policy of Rs. 60,000 which was subject to the average clause. From the books of accounts, the following particulars are available relating to the period 1st January to 30th March 20X2.

Stock as per Balance Sheet at 31st December, 20X1	Rs. 95,600
Purchases (including purchase of machinery costing Rs. 30,000)	Rs. 1,70,000
Wages (including wages Rs. 3,000 for installation of machinery)	Rs. 50,000
Sales (including goods sold on approval basis amounting to Rs. 49,500) No approval has been received in respect of 2/3rd of the goods sold on approval.	Rs. 2,75,000
The average rate of gross profit is 20% of sales.	
The value of the salvaged goods	Rs. 12,300

You are required to compute the amount of the claim to be lodged to the insurance company.

Illustration – 7

A fire occurred on 1st February, 20X2, in the premises of Pioneer Ltd., a retail store and business were partially disorganised up to 30th June, 20X2. The company was insured under a loss of profits for Rs. 1,25,000 with a six months period indemnity.

From the following information, compute the amount of claim under the loss of profit policy assuming entire sales during interrupted period was due to additional expenses.

	Rs.
Actual turnover from 1st February to 30th June, 20X2	80,000
Turnover from 1st February to 30th June, 20X1	2,00,000
Turnover from 1st February, 20X1 to 31st January, 20X2	4,50,000
Net Profit for last financial year	70,000
Insured standing charges for last financial year	56,000
Total standing charges for last financial year	64,000
Turnover for the last financial year	4,20,000

1. The company incurred additional expenses amounting to Rs. 6,700 which reduced the loss in turnover.
2. There was also a saving during the indemnity period of Rs. 2,450 in the insured standing charges as a result of the fire.
3. There had been a considerable increase in trade since the date of the last annual accounts and it has been agreed that an adjustment of 15% be made in respect of the upward trend in turnover.

Illustration - 8

The premises of XY Limited were partially destroyed by fire on 1st March, 20X2 and as a result, the business was practically disorganized upto 31st August, 20X2.
The company is insured under a **loss of profits policy for Rs.1,65,000** having an **indemnity period of 6 months**.
From the following information, prepare a claim under the policy:

		(Rs.)
(i)	Actual turnover during the period of dislocation (1-3-20X2 to 31-8-20X2)	80,000
(ii)	Turnover for the corresponding period (dislocation) in the 12 months immediately before the fire (1-3-20X1 to 31-8-20X1)	2,40,000
(iii)	Turnover for the 12 months immediately preceding the fire (1-3-20X1 to 28-2-20X2)	6,00,000
(iv)	Net profit for the last financial year	90,000
(v)	Insured standing charges for the last financial year	60,000
(vi)	Uninsured standing charges	5,000
(vii)	Turnover for the last financial year	5,00,000

Due to substantial increase in trade, before and up to the time of the fire, it was agreed that an adjustment of 10% should be made in respect of the upward trend in turnover.
The company incurred additional expenses amounting to Rs.9,300 immediately after the fire and but for this expenditure, the turnover during the period of dislocation would have been only Rs.55,000.

There was also a saving during the indemnity period of Rs.2,700 in insured standing charges as a result of the fire.

Illustration - 9

From the following particulars, you are required to calculate the amount of claim for Buildwell Ltd., whose business premises was partly destroyed by fire:

Sum insured (from 31st December 20X1)	Rs. 4,00,000
Period of indemnity	12 months
Date of damage	1st January, 20X2
Date on which disruption of business ceased	31st October, 20X2

The subject matter of the policy was gross profit but only net profit and insured standing charges are included.
The books of account revealed:
(a) The gross profit for the financial year 20X1 was Rs. 3,60,000.
(b) The actual turnover for financial year 20X1 was Rs.12,00,000 which was also the turnover in this case.
(c) The turnover for the period 1st January to 31st October, in the year preceding the loss, was Rs.10,00,000.
During dislocation of the position, it was learnt that in November-December 20X1, there has been an upward trend in business done (compared with the figure of the previous years) and it was stated that had the loss not occurred, the trading results for 20X2 would have been better than those of the previous years.
The Insurance company official appointed to assess the loss accepted this view and adjustments were made to the pre-damaged figures to bring them up to the estimated amounts which would have resulted in 20X2.

The pre-damaged figures together with agreed adjustments were:

Period	**Pre-damaged figures**	**Adjustment to be added**	**Adjusted standard turnover**
	Rs.	Rs.	Rs.
January	90,000	10,000	1,00,000
Feb. to Oct.	9,10,000	50,000	9,60,000
Nov. to Dec.	2,00,000	10,000	2,10,000
	12,00,000	**70,000**	**12,70,000**
Gross Profit	3,60,000	46,400	4,06,400

1. Rate of Gross Profit
    - 30% (actual for 20X1),

- 32% (adjusted for 20X2).

2. Increased cost of working amounted to Rs.1,80,000.
3. There was a clause in the policy relating to savings in insured standard charges during the indemnity period and this amounted to Rs.28,000.
4. Standing Charges not covered by insurance amounted to Rs.20,000 p.a.
5. The annual turnover for January was nil and for the period February to October 20X2 Rs.8,00,000

Illustration - 10

From the following information compute the consequential loss claim

Turnover	Rs.2,00,000
Indemnity Period	6 months
Period of interruption	1st Jul to 31st Oct
Net Profit	Rs.18,000
Standing Charges (includes Rs.10,000 which has not been insured)	Rs.42,000
Sum assured	Rs.50,000
Standard Turnover	Rs. 65,000
Turnover in the period of interruption (Rs. 6,000 rent @ Rs.600 per month)	Rs. 25,000
Annual Turnover	Rs.2,40,000
Savings in insured standing charges	Rs.4,725 p.a

It was agreed between the insurer and insured that the business trends would lead to an increase of 10% in the turnover.
Compute the consequential claim of loss of profit.

Important Note: Calculate additional cost of working by considering gross profit on last financial year's turnover instead of adjusted annual turnover.

Illustration - 11

Sony Ltd.'s. Trading and profit and loss account for the year ended 31st December 20X1 were as follows:

<u>Trading and Profit and Loss Account for the year ended 31.12.20X1</u>

		Rs.			Rs.
To	Opening stock	20,000	By	Sales	10,00,000
To	Purchases	6,50,000	By	Closing stock	90,000
To	Manufacturing expenses	1,70,000			

To	Gross profit	2,50,000			
		10,90,000			**10,90,000**
To	Administrative expenses	80,000	By	Gross profit	2,50,000
To	Selling expenses	20,000			
To	Finance charges	1,00,000			
To	Net profit	50,000			
		2,50,000			**2,50,000**

The company had taken out a fire policy for Rs. 3,00,000 and a loss of profits policy for Rs.1,00,000 having an indemnity period of 6 months. A fire occurred on 1.4.20X2 at the premises and the entire stock were gutted with nil salvage value. The net quarter sales i.e. 1.4.20X2 to 30.6.20X2 was severely affected.

The following are the other information:

Particulars	**Period**	**Rs.**
Sales during the period	1.1.X2 to 31.3.X2	2,50,000
Purchases during the period	1.1.X2 to 31.3.X2	3,00,000
Manufacturing expenses	1.1.X2 to 31.3.X2	70,000
Sales during the period	1.4.X2 to 30.6.X2	87,500
Standing charges insured		50,000
Actual expense incurred after fire		60,000

The general trend of the industry shows an increase of sales by 15% and decrease in GP by 5% due to increased cost.
Ascertain the claim for stock and loss of profit.

HIRE PURCHASE AND INSTALMENT SALE TRANSACTIONS

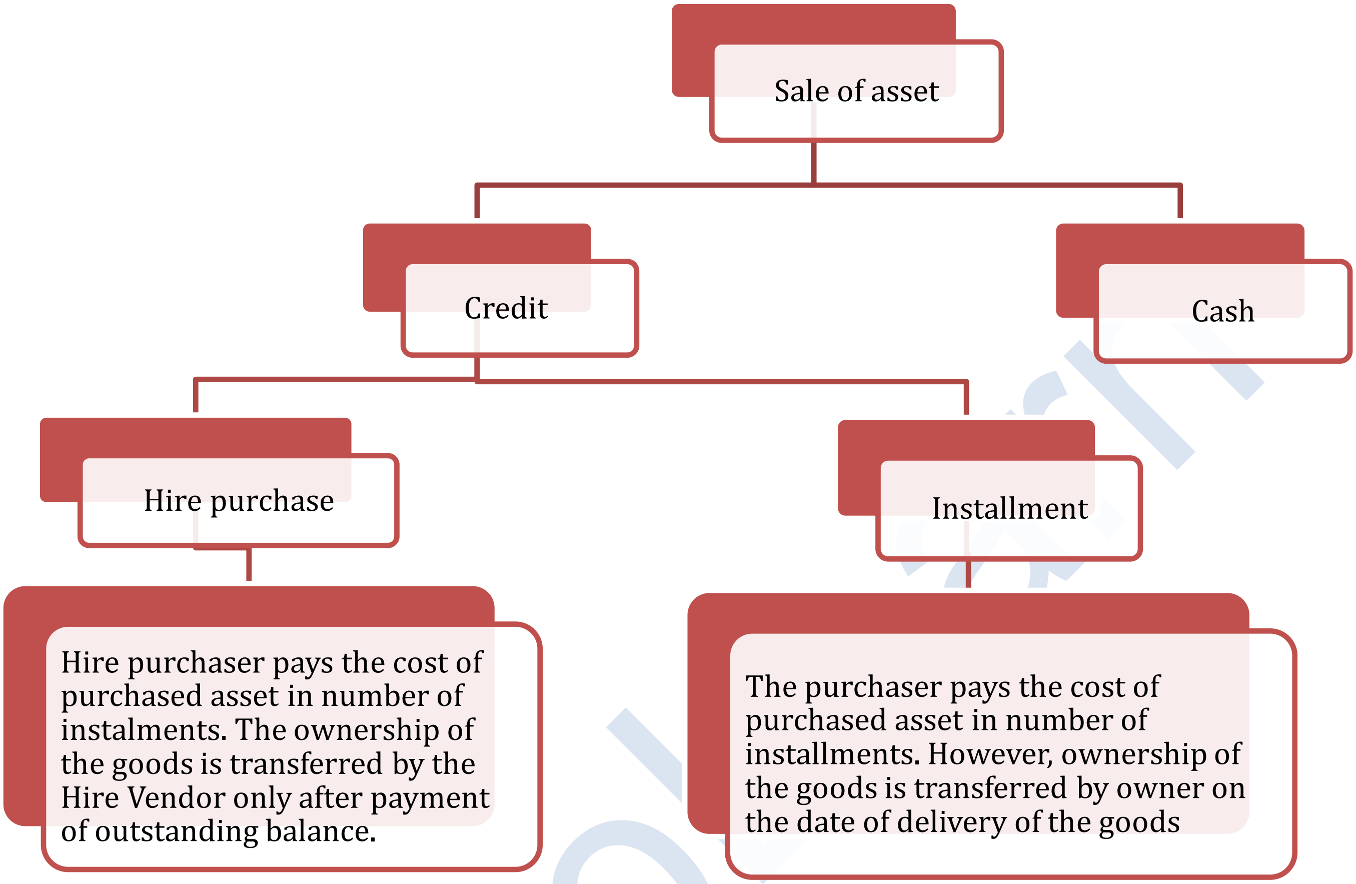
INTRODUCTION

★ When a person wants to acquire an asset, but is unable to make the payment immediately, he may pay in instalments if the vendor agrees. This enables the purchaser to use the asset while paying for it in instalments over an agreed period of time.

★ The agreed instalments include interest on the assets given on credit to the purchaser. Therefore, the total amount (being paid in instalments over a period of time) is certainly higher than the cash down price of the asset because of interest charges.

★ Both the parties gain in the bargain. By virtue of this,

  - The purchaser - gets the right of immediate use of the asset without making immediate payment for the asset, by this, he gets both credit and product from the same seller.
  - The seller - derives the benefits by way of increase in sales and, he recovers his own cost of credit.



FEATURES OF HIRE PURCHASE TRANSACTIONS

★ **Possession**: The hire vendor transfers only possession of the goods to the hire purchaser immediately after the contract for hire purchase is made.

★ **Installments**: The goods are delivered by the hire vendor on the condition that a hire purchaser should pay the amount in periodical instalments.

★ The total amount (being paid in instalments over a period) is certainly higher than the cash down price of the asset because of interest charges.

★ **Down Payment:** The hire purchaser generally makes a down payment, i.e., an amount on signing the agreement.

★ **Constituents of Hire purchase instalments**: Each instalment consists of two elements-
Finance charge (interest on unpaid amount) and Capital payment.

★ **Ownership**: The property in goods is to pass to the hire purchaser on the payment of the last instalment and exercising the option conferred upon him under the agreement.

- ★ **Repossession**: In case of default in respect of payment of even the last instalment, the hire vendor has the right to take the goods back without making any compensation. i.e., the hire vendor is not going to pay back a part or whole of the amount received through instalments till the date of default from the buyer

FEATURES OF INSTALLMENT BASIS TRANSACTIONS

- ★ **Ownership** - In instalment payment system, the ownership of the goods is passed immediately to the buyer on the signing the agreement.
- ★ **Other features similar to Hire purchase are**
  - ➢ Possession,
  - ➢ Installments
  - ➢ Down payment and
  - ➢ Constituents of Instalments.
- ★ **Court proceedings** – In the event of default by the purchaser, the seller cannot repossess the goods. He can only sue the purchase and allow the court to take action.

TERMS USED

- ★ **Hire Vendor**: He is a person who delivers the goods along with its possession to the hire purchaser under a hire purchase agreement.
- ★ **Hire Purchaser**: He is a person who obtains the goods and rights to use the same from hire vendor under a hire purchase agreement.
- ★ **Cash Price**: Cash price is the amount to be paid by the buyer on outright purchase in cash.
- ★ **Down Payment**: Down payment is the initial payment made to the hire vendor by the hire purchaser at the time of entering into a hire purchase agreement.
- ★ **Hire Purchase Instalment**: Hire purchase instalment is the amount which the hire purchaser must pay after a regular interval up to certain period as specified in the agreement to obtain the ownership of the asset purchased (on payment of the last installment) under a hire purchase agreement. It comprises of principal amount and the interest on the unpaid amount.
- ★ **Hire purchase price**: It means the total sum payable by the hire purchaser to obtain the ownership of the asset purchased under hire purchase agreement.

  HP price = Cash price (+) Interest on outstanding balances

DISTINCTION BETWEEN HIRE PURCHASE AND INSTALMENT SYSTEM

Basis of distinction	Hire Purchase	Instalment System
Governing Act	It is governed by Hire Purchase Act, 1972.	It is governed by the Sale of Goods Act, 1930.
Nature of contract	It is an agreement of hiring.	It is an agreement of sale.
Passing of Title (ownership)	The title to goods passes on last payment.	The title to goods passes immediately as in the case of usual sale.
Right to Return goods	The hirer may return goods without further payment except for accrued instalments.	Unless seller defaults, goods are not returnable.
Seller's right to repossess	The seller may take possession of the goods if hirer is defaults, in whatever condition they are at that time. A separate charge on this account cannot be made.	The seller can sue for price if the buyer is in default. He cannot take possession of the goods.
Right of Disposal	Hirer cannot hire outsell, pledge or assign entitling transferee to retain possession as against the hire vendor.	The buyer may dispose off the goods and give good title to the bona fide purchaser.
Responsibility for Risk of Loss.	The hirer is not responsible for risk of loss of goods if he has taken reasonable precaution because the ownership has not yet transferred.	The buyer is responsible for risk of loss of goods because of the ownership has transferred.
Name of Parties involved	The parties involved are called Hirer and Hire vendor	The parties involved are called buyer and seller.
Component other than cash price.	Component other than Cash Price included in installment is called Hire charges.	Component other than Cash Price included in Installment is called Interest.
Conditions When goods are sold on	1.When goods cannot be destroyed easily.	If the conditions of HP and not satisfied, they will be sold on

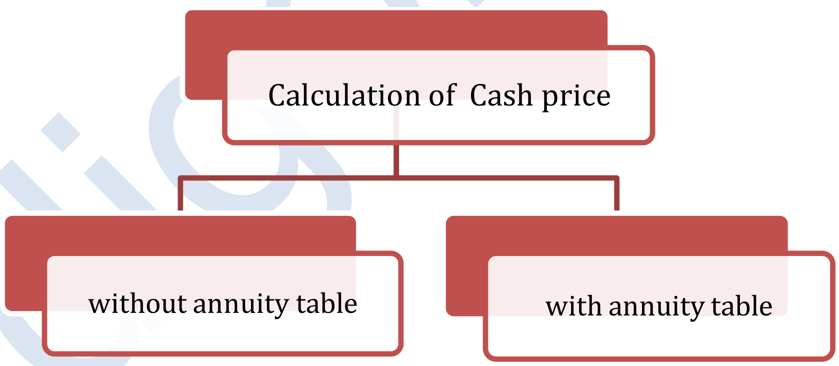
HP and when on Instalment	2. when goods can be insured 3. when goods have resale value. E.g. Car, Bike, House etc.	installment basis. For E.g. Household goods – TV, Fridge, AC etc.

Key points to be kept in mind while solving the problems

1. Down payment does not include any interest.
2. Interest is always calculated on total amount outstanding at the time of payment of installment.
3. Though the instalments of a hire purchase agreement may be equal, the interest element in each instalment is not the same.
4. Interest element in the 1st installment is > interest in 2nd installment. So on and so forth.
5. Total interest = HP price – Cash price

COMPUTING HIRE PURCHASE DETAILS

I. ASCERTAINMENT OF TOTAL CASH PRICE



I.(a) Calculation of Total Cash Price without using Annuity Table

In this method, the interest included in the last instalment is to be calculated first with the help of the appropriate formula

For example, in a hire purchase transaction, apart from down payment, four other instalments are payable. The interest will be calculated first on the 4th instalment, then on the 3rd instalment, then on the 2nd instalment and lastly on the 1st instalment. Interest on down payment will be nil.

The amount of interest will go on increasing from the 4th instalment to the 3rd instalment, so on and so forth.

We need to calculate the interest with the help of the total amount due on hire purchase price since the cash price is not known. The following steps should be followed:

Step 1	Calculate the ratio between interest and the amount due Ratio of interest and amount due = $\frac{\text{Rate of interest}}{100 + \text{Rate of interest}}$
Step 2	Calculate the interest included in the last instalment Interest = Total amount due at the time of instalment **x** Ratio of interest and amount due (as calculated in step 1)
Step 3	Amount of outstanding cash price at the time of last instalment = Last instalment – Interest (as calculated in step 2)
Step 4	Amount due at the time of previous installment = Cash price (computed in Step 3) **+** Amount of instalment due at the end the previous year.
Step 5	Calculate the interest on the entire sum. Amount due (computed in step 4) X Ratio arrived at step 1
Step 6	Outstanding cash price at the time of that instalment = Total amount due at the end of that year (Step 4) **-** Interest (step 5)
Step 7	Repeat steps 4 to 6, to reach at 1st installment. Compute Amount due at the time of previous installment. Calculate the interest on the entire sum. Compute Outstanding cash price at the time of that instalment
Step 10	Total cash price = Cash price (computed in Step 7) **+** Amount of down payment, if any.

I.(b) Calculation of Total Cash Price with the help of Annuity Table

Cash price = Down payment + Present value of instalments

1. If present value of an annuity of Rs. 1 for a given period, at given rate of interest, is given

Present value of instalments = Annual instalments **x** Present value of an annuity of Rs. 1 for a given period at given rate of interest

$$= \text{Annual instalments} \times \frac{(1+r)^n - 1}{r(1+r)^n}$$

2. If annuity to recover Rs. 1 during a given period at given rate of interest is given,

$$\text{Present value of instalments} = \text{Annual instalments} \times \frac{(1+r)^n - 1}{r}$$

$(1 + r)^n - 1$

II. ASCERTAINMENT OF INTEREST

2 Possible situations may arise:

II.(a) - When the cash price, rate of interest and the amount of instalments are given.

Step 1 Calculate the total amount of interest: - Interest = Hire purchase price – Cash price Now the amount of interest involved in each instalment is to be calculated.			
Particulars	Total	Interest in each instalment	Cash price in each instalment
Step 2			
Cash price Less: down payment Balance due after down payment (a) Interest Cash price in 1st instalment	xxxx (xxx) xxxx	 Balance x rate of interest	 Instalment - Interest
Step 3			
Cash price in 1st instalment (b) Balance due after 1st Instalment (a-b) = (c) Interest	(xxx) xxxx	 Balance x rate of interest	

Cash price in 2nd instalment			Instalment - Interest
Step 4			
Cash price in 2nd instalment (d) Balance due after 1st Instalment (c-d) = (e) Interest Cash price in 3rd instalment	(xxx) xxxx	 Balance x rate of interest	 Instalment - Interest
Step 5 Repeat the above steps till the last instalment is paid		This gives the total interest paid	This gives the hire purchase price.

II. (b) - When the cash price and the amount of instalments are given, but the rate of interest is not given.

Method 1

When the rate of interest is not given, but the cash price and the amount of installments are given, we have to find interest rate implicit in the transaction by bifurcating the installments between reduction in liability and finance charges (interest).

Step 1

Calculate the total amount of interest: - Interest = Hire purchase price – Cash price

Step 2

Bifurcate the interest in the ratio of amount outstanding.

Method 2

Use IRR.

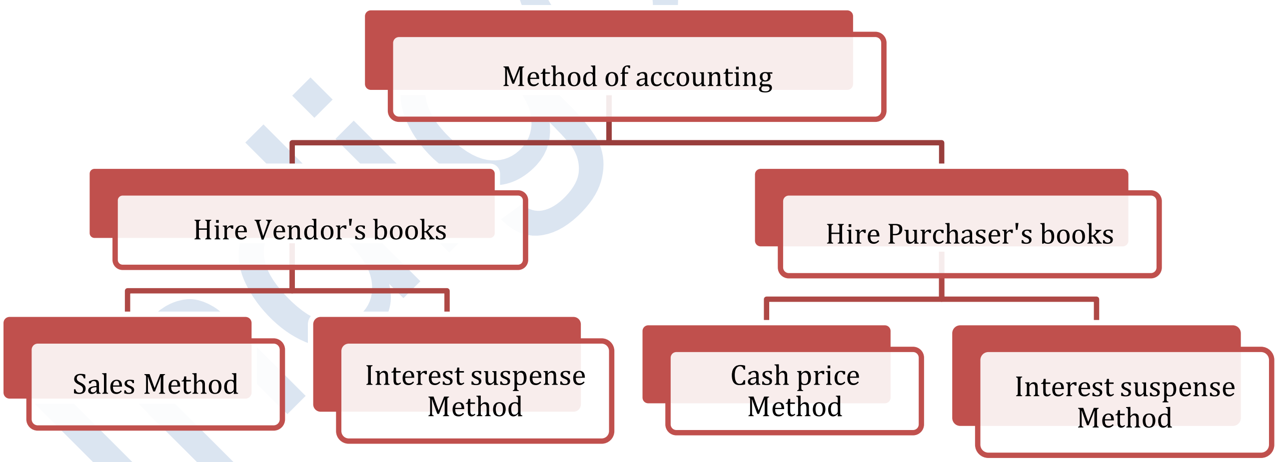
Internal rate of return (IRR) is the discount rate that equates the present value of the expected net cash outflows (amount of down-payment and installments) with the cash price. When the net cash flows are not uniform over the life of the investment, the determination of the discount rate can involve trial and error and interpolation between interest rates.

In case of hire purchase, Internal Rate of Return Method (IRR) method considers the time value of money, the cash price, and all cash outflows (amount of down-payment and installments) relating to the purchase of the asset on hire purchase basis.

IRR method does not use the desired rate of return but estimates the discount rate that makes the present value of subsequent net cash outflows equal to the cash price.

Step 1	Compute NPV at an initial guess rate (say L1) Aggregate of Cash flow of each year x Discounting factor @ L1 of each year = Present Value
Step 2	Compute NPV at second guess rate (say L2) Aggregate of Cash flow of each year x Discounting factor @ L2 of each year = Present Value
Step 3	Compute IRR through Linear intrapoliation $\text{IRR} = \text{L1} + \frac{\text{NPV of L1}}{\text{NPV of L1} - \text{NPV of L2}} \times (\text{L2}-\text{L1})$

METHOD OF ACCOUNTING



IN THE BOOKS OF HIRE PURCHASER

To have proper accounting record, one should know the following:
(1) Date of purchase of the asset;
(2) Cash price of the asset;
(3) Hire purchase price of the asset;

(4) The amount of down payment;
(5) Number and amount of each instalment;
(6) Rate of interest;
(7) Method and rate of depreciation;
(8) Date of payment of every instalment; and
(9) Date of closing the books of account.

Disclosure requirement

- Disclose assets taken on hire purchase basis by classifying it as "Asset on Hire Purchase".
- Amount due to the hire vendor should also be shown as a liability—"Hire Purchase Creditors" with additional such classifications of amount of 'hire purchase instalment due' and 'amount of hire purchase instalment not yet due'.
- Asset is shown at cost (cash price) less depreciation.

CASH METHOD

Under this method, at the time of payment of instalment, Interest Account is debited, and Hire Vendor Account is credited (with the interest on outstanding balance). At the end of the year interest is transferred to Profit and Loss Account.

Journal Entries

1.	At the time of entering into the agreement Asset Account Dr. To Hire Vendor Account	[Full cash price]
2.	When down payment is made Hire Vendor Account Dr. To Cash/Bank Account	[Down payment]
3.	When an instalment becomes due Interest Account Dr. To Hire Vendor Account	[Interest on outstanding balance]
4.	When an instalment is paid Hire Vendor Account Dr. To Bank Account	[Amount of instalment]

5.	When depreciation is charged on the asset Depreciation Account Dr. To Asset Account	[Calculated on cash price]
6.	For closing interest and depreciation account Profit and Loss Account Dr. To Interest Account To Depreciation Account	

INTEREST SUSPENSE METHOD Under this method, at the time of transfer of possession of asset, the total interest unaccrued is transferred to interest suspense account. At later years, as and when interest becomes due, interest account is debited, and interest suspense account is credited.			
Journal Entries			
1.	When the asset is acquired on hire purchase Asset Account To Hire Vendor Account	Dr.	[Full cash price]
2.	For total interest payment H.P. Interest Suspense Account To Hire Vendor Account	Dr.	[Total interest]
3.	When down payment is made Hire Vendor Account To Bank Account	Dr.	
4.	For Interest of the relevant period Interest Account To H.P. Interest Suspense Account	Dr.	[Interest of the relevant period]
5.	When an instalment is paid Hire Vendor Account To Bank Account	Dr.	
6.			

	When depreciation is charged Depreciation Account To Asset Account	Dr. [Calculated on cash price]
7.	For closing interest and depreciation Profit and Loss Account To Interest Account To Depreciation Account	Dr.

IN THE BOOKS OF HIRE VENDOR

Out of the two method (i.e. sales method and interest suspense method) the selection of the method is based on the type and value of goods sold, volume of transactions, the length of the period of purchase, etc.

The entire profit on sale under hire purchase agreement is credited to the Profit and Loss account of the year in which the sale has taken place.

Interest pertaining to each accounting period is credited to the P&L A/c of the respective year.

Sales method		
Journal Entries		
1.	When goods are sold and delivered under hire purchase Hire Purchaser Account Dr. To H.P. Sales Account	[Full cash price]
2.	When the down payment is received Bank Account Dr. To Hire Purchaser Account	
3.	When an instalment becomes due Hire Purchaser Account Dr. To Interest Account	
4.	When the amount of instalment is received Bank Account Dr. To Hire Purchaser Account	
5.	For closing interest Account Interest Account Dr. To Profit and Loss Account	.
6.	For closing Hire Purchase Sales Account H.P. Sales Account Dr. To Trading Account	

<u>Interest Suspense Method</u>		
<u>Journal Entries</u>		
1.	When goods are sold and delivered under hire purchase Hire Purchaser Account Dr. To H.P. Sales Account To Interest suspense account	[Full cash price + total interest] [Full cash price] [Total interest]
2.	When the down payment is received Bank Account Dr. To Hire Purchaser Account	
3.	For interest of relevant accounting period Interest suspense Account Dr. To Interest Account	
4.	When the amount of instalment is received Bank Account Dr. To Hire Purchaser Account	
5.	For closing interest Account Interest Account Dr. To Profit and Loss Account	.
6.	For closing Hire Purchase Sales Account H.P. Sales Account Dr. To Trading Account	

<u>The disclosure in balance sheet of the respective parties will be:</u>

Balance Sheet of Hire Purchaser	Balance Sheet of Vendor
Assets	Assets
Fixed assets:	Current assets:
Asset on Hire purchase Less: Depreciation	Hire purchase debtors Less: Balance in Interest suspense A/c
Liabilities	Liabilities
Amount payable to Vendor Less: Balance in Interest Suspense A/c	

ACCOUNTING UNDER INSTALMENT PAYMENT SYSTEM

In instalment payment system, the ownership of the goods is passed immediately to the buyer on the signing the agreement. The accounting entries under instalment payment system are similar to those passed under the hire-purchase system. The scheme of entries is as under:

Journal entries in the books of Buyer	
For Purchase of asset Asset A/c Interest suspense A/c To Vendor's A/c	 Dr. (with full cash price) Dr. (with difference between full cash price & installment price (With full installment price)
Upon interest becoming due Interest A/c To Interest suspense A/c	 Dr.
Every year interest account is debited, and interest suspense account is credited with the interest of current year.	
Upon payment of Installment Vendor's A/c To Cash A/c	 Dr.
At the end of the year P&L A/c To Interest A/c	 Dr.

Note:

The balance of vendor account should be shown in the balance sheet after deducting amount in interest suspense account.

Vendor is paid the instalment due to him and entry for the depreciation is passed in the usual way.

Journal entries in the books of Seller	
For Sale of asset Buyer's A/c To Sales A/c To Interest suspense A/c	 Dr. (with full Installment price) (with full cash price) (with difference between full cash price & installment price
Upon interest becoming due Interest suspense A/c To Interest A/c	 Dr.
Every year this entry is passed with the interest of current year.	
Upon receipt of Installment Cash A/c To Purchaser A/c	 Dr.
At the end of the year Interest A/c To P&L A/c	 Dr.

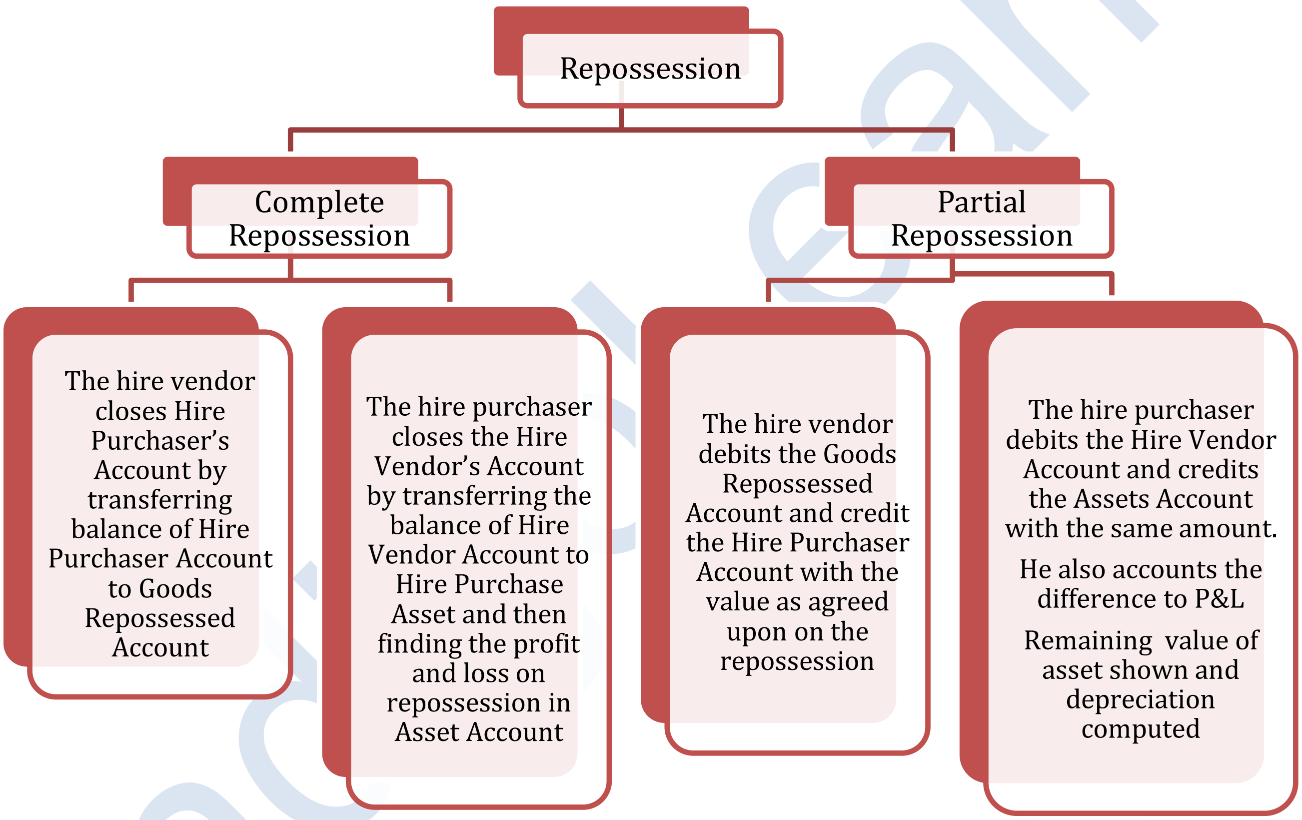
REPOSSESSION

- ★ If the hire purchaser fails to pay any of the instalments, the hire vendor takes the asset back in its actual form without any refund of the earlier payments to the hire purchaser.
- ★ The amounts received from the hire purchaser through down payment and instalments are treated as the hire charges by the hire vendor.
- ★ This act of recovery of possession of the asset is termed as repossession.
- ★ Repossessed assets are resold to any other customer after repairing or reconditioning (if necessary).

★ Accounting figures relating to repossessed assets are segregated from the normal hire purchase entries. Repossessions are then accounted for in a separate “Goods Repossessed Account”.

★ In case of a partial repossession, only a part of the asset is taken back by the hire vendor and other part is left with the hire purchaser.

★ Assets are repossessed at a mutually agreed value (based on agreed rate of depreciation which is an enhanced rate).



COMPLETE REPOSSESSION	
Journal entries in the books of hire purchaser	
For purchases Asset A/c To Hire vendor A/c	 Dr.
Upon payment of instalment Hire vendor A/c To Cash A/c	 Dr.

Upon payment of interest Interest A/c To Hire vendor A/c	Dr.
Upon repossession Hire vendor A/c To Asset A/c	Dr.

COMPLETE REPOSSESSION	
Journal entries in the books of hire Vendor	
For sales made Hire purchase A/c To Sales A/c	Dr.
Upon receipt of instalment Cash A/c To Hire purchaser A/c	Dr.
Upon receipt of interest Hire purchaser A/c To Interest A/c	Dr.
Upon repossession Goods repossessed A/c To Hire purchaser A/c	Dr.

Illustrations

Illustration - 1

Asha purchased a truck on hire purchase system. As per terms he is required to pay Rs.70,000 down, Rs.53,000 at the end of first year, Rs.49,000 at the end of second year and Rs.55,000 at the end of third year. Interest is charged @ 10% p.a. You are required to calculate the total cash price of the truck and the interest paid with each instalment.

Illustration - 2

A acquired on 1st January, 20X1 a machine under a Hire-Purchase agreement which provides for 5 half-yearly instalments of Rs.6,000 each, the first instalment being due on 1st July, 20X1.
Assuming that the applicable rate of interest is 10 per cent per annum, calculate the cash value of the machine. All workings should form part of the answer.

Illustration -3

On 1st April, 20X1 a manufacturing company buys on Hire-purchase system a machinery for Rs.90,000 payable by three equal annual instalments combining principal and interest, the rate of interest was 5% per annum.
Calculate the amount of cash price and interest. Assume that the present value of an annuity of one rupee for three years at 5% interest is Rs.2.723.

Illustration - 4

Om Ltd. purchased a machine on hire purchase basis from Kumar Machinery Co. Ltd. on the following terms:
(a) Cash price Rs.80,000
(b) Down payment at the time of signing the agreement on 1.1.20X1 Rs.21,622.
(c) 5 annual instalments of Rs.15,400, the first to commence at the end of twelve months from the date of down payment.
(d) Rate of interest is 10% p.a.
You are required to calculate the total interest and interest included in cash instalment.

Illustration – 2 (Alternate method)

A acquired on 1st January, 20X1 a machine under a Hire-Purchase agreement which provides for 5 half-yearly instalments of Rs.6,000 each, the first instalment being due on 1st July, 20X1. Assuming that the applicable rate of interest is 10 per cent per annum, calculate the cash value of the machine. All workings should form part of the answer.

Illustration - 5

A Happy Valley Florists Ltd. acquired a delivery van on hire purchase on 01.04.20X1 from Ganesh Enterprises. The terms were as follows:

Particulars	Amount (Rs.)
Hire Purchase Price	180,000
Down Payment	30,000
1st installment payable after 1 year	50,000
2nd installment after 2 years	50,000
3rd installment after 3 years	30,000
4th installment after 4 years	20,000

Cash price of van Rs.150,000 You are required to calculate Total Interest and Interest included in each instalment.

Illustration - 6

On January 1, 20X1 HP M/s acquired a Pick-up Van on hire purchase from FM M/s. The terms of the contract were as follows:

1. The cash price of the van was Rs.1,00,000.
2. Rs.40,000 were to be paid on signing of the contract.
3. The balance was to be paid in annual instalments of Rs.20,000 plus interest.
4. Interest chargeable on the outstanding balance was 6% p.a.
5. Depreciation at 10% p.a. is to be written-off using the straight-line method.

You are required to:

a. Give Journal Entries and show the relevant accounts in the books of HP M/s from January 1, 20X1 to December 31, 20X3; and
b. Show the relevant items in the Balance Sheet of the purchaser as on December 31, 20X1 to 20X3.

Illustration - 7

On January 1, 20X1 HP M/s acquired a Pick-up Van on hire purchase from FM M/s. The terms of the contract were as follows:

1. The cash price of the van was Rs.1,00,000.
2. Rs.40,000 were to be paid on signing of the contract.
3. The balance was to be paid in annual instalments of Rs.20,000 plus interest.
4. Interest chargeable on the outstanding balance was 6% p.a.
5. Depreciation at 10% p.a. is to be written-off using the straight-line method.

Assume that the hire purchaser adopted the interest suspense method for recording his hire purchase transactions. On this basis, prepare Hire Purchase Interest Suspense Account, Interest Account and FM M/s Accounts and Balance Sheets in the books of hire purchaser.

Illustration - 8

X Ltd. purchased 3 milk vans from Super Motors costing Rs.75,000 each on hire purchase system.
Payment was to be made: Rs.45,000 down and the remainder in 3 equal instalments together with interest @ 9%. X Ltd. writes off depreciation @ 20% on the diminishing balance. It paid the instalment at the end of the 1st year but could not pay the next.

Super Motor agreed to leave one milk van with the purchaser, adjusting the value of the other two milk vans against the amount due. The milk vans were valued on the basis of 30% depreciation annually on written down value basis. X Ltd. settled the seller's dues after three months.

You are required to give necessary journal entries and the relevant accounts in the books of X Ltd.

Illustration - 9

1. X Transport Ltd. purchased from Delhi Motors 3 Tempos costing Rs. 50,000 each on the hire purchase system on 1-1-20X1.
2. Payment was to be made Rs. 30,000 down and the remainder in 3 equal annual instalments payable on 31-12-20X1, 31-12-20X2 and 31-12-20X3 together with interest @ 9%.
3. X Transport Ltd. write off depreciation at the rate of 20% on the diminishing balance.
4. It paid the instalment due at the end of the first year i.e. 31-12-20X1 but could not pay the next on 31-12-20X2.
5. Delhi Motors agreed to leave one Tempo with the purchaser on 1-1-20X3 adjusting the value of the other 2 Tempos against the amount due on 31-12-20X2.
6. The Tempos were valued on the basis of 30% depreciation annually.

Show the necessary accounts in the books of X Transport Ltd. for the years 20X1, 20X2 and 20X3.

Illustration - 10

A firm acquired two tractors under hire purchase agreements, details of which were as follows:

Date of Purchase	**Tractor A** **1st April, 20X1(Rs.)**	**Tractor B** **1st Oct., 20X1(Rs.)**
Cash price	14,000	19,000

Both agreements provided for payment to be made in twenty-four monthly instalments (of Rs. 600 each for Tractor A and Rs. 800 each for Tractor B), commencing on the last day of the month following purchase, all instalments being paid on due dates.

On 30th June, 20X2, Tractor B was completely destroyed by fire. In full settlement, on 10th July, 20X2 an insurance company paid Rs. 15,000 under a comprehensive policy. Any balance on the hire purchase company's account in respect of these transactions was to be written off.

The firm prepared accounts annually to 31st December and provided depreciation on tractors on a straight-line basis at a rate of 20 % p.a. rounded off to nearest ten rupees, apportioned as from the date of purchase and up to the date of disposal
You are required to record these transactions in the following accounts, carrying down the balances on 31st December, 20X1 and 31st December, 20X2:

(a) Tractors on hire purchase.
(b) Provision for depreciation of tractors.
(c) Disposal of tractors.

Illustration – 11

A machinery is sold on hire purchase. The terms of payment is four annual instalments of Rs. 6,000 at the end of each year commencing from the date of agreement. Interest is charged @ 20% and is included in the annual payment of Rs. 6,000.

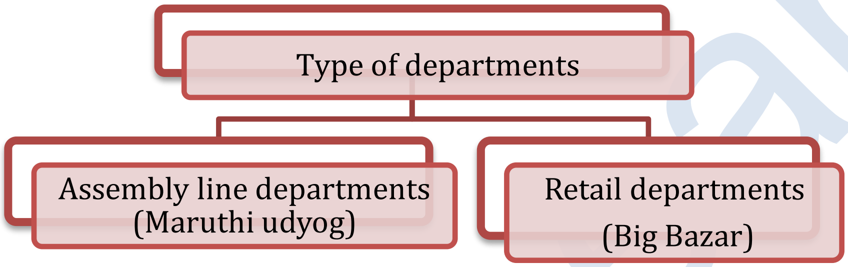
Show Machinery Account and Hire Vendor Account in the books of the purchaser who defaulted in the payment of the third yearly payment whereupon the vendor re-possessed the machinery.

The purchaser provides depreciation on the machinery @ 10% per annum on WDV basis. All workings should form part of your answers.

DEPARTMENTAL ACCOUNTS

INTRODUCTION

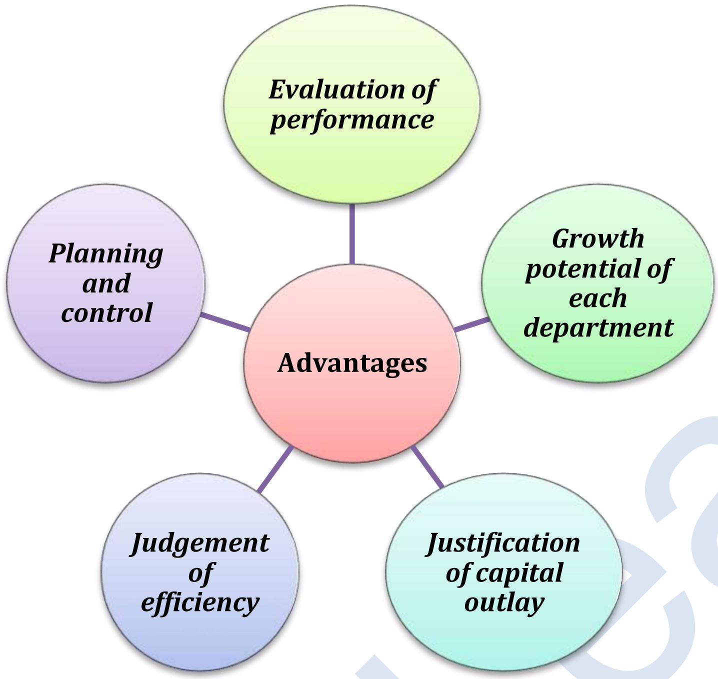
If a business consists of several independent activities, or is divided into several departments, for carrying on separate functions, its management is usually interested in finding out the working results of each department to ascertain their relative efficiencies. Thus departmental accounts are prepared.
An organization usually divides the work in various departments, which is done on the principle of division of labour.



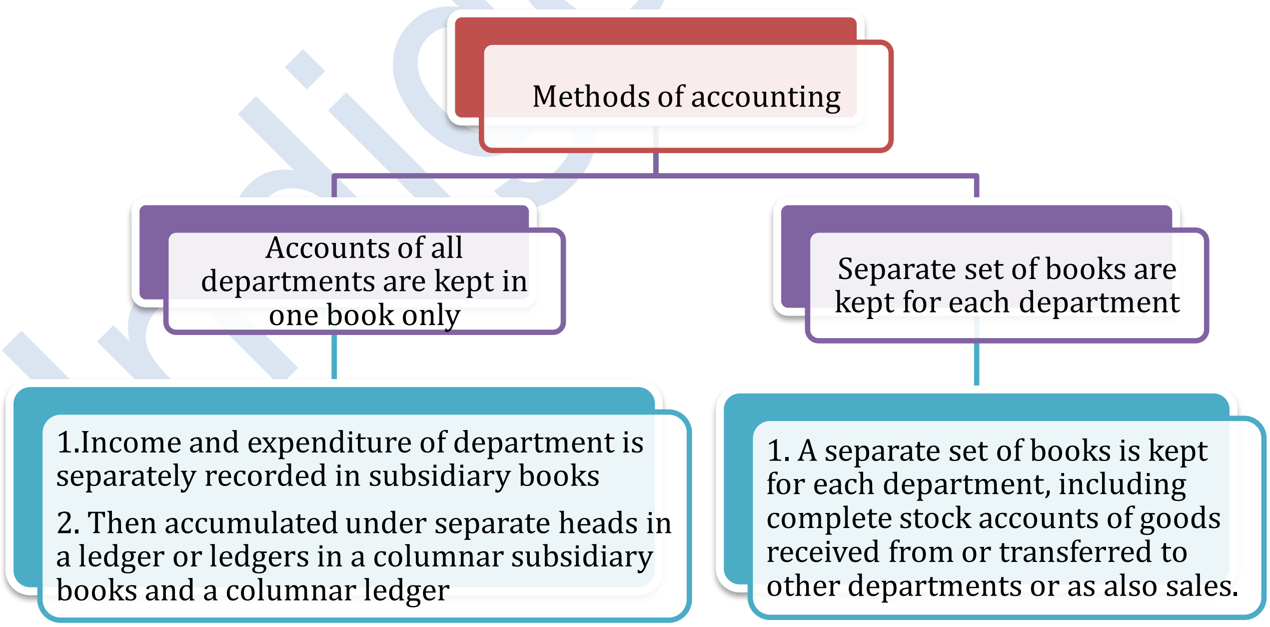
OBJECTIVE

- Calculate profit for each department. Columnar Trading and P&L account is prepared where each column represents a department.
- Readily identify wastage of material and wastage of money
- Identify inefficiencies in each department and work towards its improvement.

ADVANTAGES OF DEPARTMENTAL ACCOUNTING



METHODS OF ACCOUNTING



BASIS OF ALLOCATION OF COMMON EXPENDITURE AMONG DIFFERENTDEPARTMENTS

Individual Identifiable Expenses: Expenses incurred specially for a particular department are charged directly there to e.g. insurance charges of stock held by the department.

Common Expenses: Common expenses, the benefit of which is shared by all the departments and which are capable of precise allocation are distributed among the departments concerned on some equitable basis considered suitable in the circumstances of the case.

Sr.No.	**Expenses**	**Basis**
1.	Rent, rates and taxes, repairs and maintenance, insurance of building	Floor are occupied by each department (if given) otherwise on time basis
2.	Lighting and heating expenses (e.g.: energy expenses)	Consumption of energy by each department.
3.	Selling expenses, e.g. ,discount, bad debts, selling commission, freight outward, travelling sales manager's salary and other costs	Sales of each department
4.	Carriage inward/ Discount received	Purchases of each department
5.	Wages/Salaries	Time devoted to each department
6.	Depreciation, insurance, repairs and maintenance of capital assets.	Value of assets of each department otherwise on time basis.
7.	Administrative and other expenses, e.g., salaries of managers, directors, common advertisement expenses, etc.	Time basis or equally among all departments.
8.	Labour welfare expenses	Number of employees in each department
9.	PF/ESI contributions	Wages and salaries of each department
10	Expenses and income, of financial nature, for example, interest on loan, profit/loss on sale of investment, etc.	Cannot be apportioned on a suitable basis; therefore they are recognised in the combined Profit and Loss Account

TYPES OF DEPARTMENTS

Independent Department

Departments which work independently of each other and have negligible inter-department transfers

Dependent Department

Departments which transfer goods from one department to another department for further processing .

The output of one department becomes the input for the other department

INTER-DEPARTMENTALTRANSFERS

- Whenever goods or services are provided by one department to another, their cost should be separately recorded and charged to the department benefiting there by and credited to that providing the goods or services.
- The totals of such benefits are disclosed in the departmental Profit and Loss Account, to distinguish them from other items of expenditure.
- The price at which this is done is known as transfer price.
- In case of dependent departments, unloading is required if the transfer price is having a profit element, i.e... the unrealized profit called the stock reserve should be eliminated.

Basis of Inter-Departmental Transfers

- Goods and services may be charged by one department to another usually on either of the following three bases:
  - 1. Cost
  - 2. Current market price
  - 3. Cost + agreed % of profit

Elimination of Unrealised Profit

- When profit is added in inter-departmental transfers the loading included in the unsold inventory at the end of the year is to be excluded before the final accounts are prepared so as to eliminate any anticipatory (internal) profit included therein.

Stock reserve

- Unrealised profit included in unsold stock at the end of accounting period is eliminated by creating an appropriate stock reserve by debiting the combined Profit and Loss Account
- In the beginning of the subsequent accounting year, the entry is reversed.
- Stock reserve is shown as a deduction from Closing stock in the balance sheet.
- Stock reserve = $\frac{\text{TP of unsold stock} \times \text{Profit included in TP}}{\text{TP}}$
- TP = Transfer price

Journal entries	
At the end of the accounting year, the following journal entry will be passed for elimination of unrealized profit (creation of stock reserve):	
Profit and Loss Account	Dr.
To Stock Reserve	
(Being a provision made for unrealized profit included in closing stock)	
In the beginning of the next accounting year, the aforesaid journal entry will be reversed as under	
Stock Reserve Dr.	
To Profit and Loss Account	
(Being provision for unrealized profit reversed)	

Disclosure in Balance Sheet	
The unsold closing stock acquired from another department will appear on the assets side of the balance sheet as under:	
(An extract of the assets side of the balance sheet)	
Current assets	xxx
Stock	xxx
Less – Stock reserve	(xx)
	xxx

MEMORANDUM STOCK AND MEMORANDUM MARK UP ACCOUNT METHOD

- Under this method, goods supplied to each department are debited to a Memorandum Departmental Stock account at cost plus a 'mark up' (loading) to give the normal selling price of the goods.
- The sale proceeds of the department are credited in Memorandum Departmental Stock account and amount of 'Mark up' is credited to the Departmental Mark up Account.
- When it is necessary to reduce the selling price below the normal selling price, i.e., cost plus mark up, the reduction (mark down) is entered in the Memorandum Stock account as well as in the Mark up account.
- This method helps to achieve effective control of stock movements of various departments.

Illustrations

Illustration 1 (Concept of Stock Reserve)

Goods are transferred from Department P to Department Q at a price 50% above cost. If closing stock of Department Q is Rs. 27,000 compute the amount of stock reserve.

Illustration 2

Z Ltd. has three departments and submits the following information for the year ending on 31st March 2011:

	A	B	C	Total
Purchases (units)	6,000	12,000	14,400	
Purchases (Rs.)	-	-	-	6,00,000
Sales (units)	6,120	11,520	14,976	
Selling Price (per unit)	40	45	50	
Closing Stock	600	960	36	

You are required to prepare departmental trading account of Z Ltd., assuming that the rate of profit on sales is uniform in each case.

Illustration 3

M/s Omega is a departmental store having three departments X, Y and Z. The information regarding three departments for the year ended 31st March, 20X1 are given below:

	Amount in Rs.		
	X	Y	Z
Opening Stock	36,000	24,000	20,000
Purchases	1,32,000	88,000	44,000
Debtors at end	15,000	10,000	10,000
Sales	1,80,000	1,35,000	90,000
Closing Stock	45,000	17,500	21,000
Value of furniture	20,000	20,000	10,000
Floor Space occupied (in sq. ft.)	3,000	2,500	2,000
No. of employees	25	20	15
Electricity Consumed (in units)	300	200	100

The balances of other revenue items in the books for the year are given below:

	Rs.
Carriage Inwards	3,000
Carriage Outwards	2,700
Salaries	48,000
Advertisement	2,700

Discount Allowed	2,250
Discount Received	1,800
Rent, Rates and Taxes	7,500
Depreciation on Furniture	1,000
Electricity Expenses	3,000
Labour Welfare Expenses	2,400

You are required to prepare Departmental Trading and Profit and Loss Account for the year ended 31st March 20X1 after providing for provision for Bad Debts at 5%.

Illustration 4

M/s X has two departments, A and B. From the following particulars prepare the consolidated Trading Account and Departmental Trading Account for the year ending 31st December, 20X1

	A (Rs.)	**B (Rs.)**
Opening Stock	20,000	12,000
Purchases	92,000	68,000
Sales	1,40,000	1,12,000
Wages	12,000	8,000
Carriage	2,000	2,000
Closing Stock		
1. Purchased goods	4,500	24,000
2. Finished goods	6,000	14,000
Purchased goods transferred:		
• by B to A	10,000	
• by A to B		8,000
Finished goods transferred:		
• by A to B 35,000	35,000	
• by B to A 40,000		40,000
Return of finished goods:		
• by A to B 10,000	10,000	
• by B to A 7,000		7,000

You are informed that purchased goods have been transferred mutually at their respective departmental purchase cost and finished goods at departmental market price and that 20% of the finished stock (closing) at each department represented finished goods received from the other department

Illustration 5

Department P sells goods to Department S at a profit of 25% on cost and to Department Q at a profit of 15% on cost.

Department S sells goods to P and Q at a profit of 20% and 30% on sales respectively.

Department Q sells goods to P and S at 20% and 10% profit on cost respectively.

Departmental Managers are entitled to 10% commission on net profit subject to unrealized profit on departmental sales being eliminated.

Departmental profits after charging Manager's commission, but before adjustment of unrealized profits are as below:

	Rs.
Department P	90,000
Department Q	60,000
Department S	45,000

Stock-lying at different Departments at the end of the year are as below:

	Departments		
	P (Rs.)	**Q (Rs.)**	**S (Rs.)**
Transfer from P	-	18,000	14,000
Transfer from S	48,000	-	38,000
Transfer from Q	12,000	8,000	-

Find out correct Departmental Profits after charging Managers' Commission.

Illustration 6

M/s Suman Enterprises has two departments, Finished Leather and Shoes. Shoes are made by the Firm itself out of leather supplied by the Leather Department at its usual selling price. From the following figures, prepare Departmental Trading Account for the year ended 31st March, 20X3:

	Finished Leather Department (Rs.)	**Shoes Department (Rs.)**
Opening Stock (as on 01.04.20X2)	30,20,000	4,30,000
Purchases	1,50,00,000	2,60,000
Sales	1,80,00,000	45,20,000
Transfer to Shoes Department	30,00,000	-
Manufacturing Expenses	-	5,00,000
Selling Expenses	1,50,000	60,000

Rent & warehousing	5,00,000	3,00,000
Stock on 31.03.20X3	12,20,000	5,00,000

The following further information is available for necessary consideration:

1. The stock in Shoes Department may be considered as consisting of 75% of leather and 25% of other expenses
2. The Finished Leather Department earned a Gross Profit @ 15% in 20X1-20X2.
3. General Expenses of the business as a whole amount to Rs.8,50,000

Illustration 7

Gram Udyog, a retail store, has two departments, 'Khadi and Silks' for each of which stock account and memorandum 'markup' accounts are kept.

All the goods supplied to each department are debited to the stock account at cost plus a 'markup', which together make-up the selling-price of the goods and in the account of the sale proceeds of the goods are credited. The amount of 'mark-up' is credited to the Departmental Markup Account.

If the selling price of any goods is reduced below its normal selling price, the reduction 'marked down' is adjusted both in the Stock Account and the Departmental 'Markup' Account.

The rate of 'Mark-up' for Khadi Department is 331/3% of the cost and for Silks Department it is 50% of the cost.

The following figures have been taken from the books for the year ended December 31, 20X1:

	Khadi Dept	**Silks Dept**
	Rs.	**Rs.**
Stock as on January 1st at cost	10,500	18,600
Purchases	75,900	93,400
Sales	95,600	1,25,000

1. The stock of Khadi on January 1, 20X1 included goods the selling price of which had been marked down by Rs. 1,260. These goods were sold during the year at the reduced prices.
2. Certain stock of the value of Rs. 6,900 purchased for the Khadi Department were later in the year transferred to the Silks department and sold for Rs.10,350. As a

result, though cost of the goods is included in the Khadi Department the sale proceeds have been credited to the Silks Department.

3. During the year 20X1 to promote sales the goods were marked down as follows:

	Cost	Marked down
	Rs.	Rs.
Khadi	5,600	360
Silk	10,000	2,000

At the time of stock-taking on December 31, 20X1 it was discovered that Khadi cloth of the cost of Rs. 390 was missing and it was decided that the amount be written off.

You are required to prepare for both the departments for the year 2012.

(a) The Memorandum Stock Account;

(b) The Memorandum Mark-up Account

Illustration 8

M/s Complex has 3 departments, A, B, C. The following information is provided:

Particulars	A (Rs.)	B (Rs.)	C (Rs.)
Opening Stock	3,000	4,000	6,000
Consumption of direct materials	8,000	12,000	-
Wages	5,000	10,000	-
Closing Stock	4,000	14,000	8,000
Sales	-	-	34,000

Stock of each department is valued at cost to the department concerned, Stocks of A department are transferred to B at a margin of 50% above departmental cost, Stocks of B department are transferred to C department at a margin of 10% above departmental cost

Other expenses were:

Particulars	Amount (Rs.)
Salaries	2,000
Printing and Stationery	1,000
Rent	6,000
Interest Paid	4,000
Depreciation	3,000

Allocate expenses in the ratio of departmental gross profit. Opening figures of reserves for unrealised profits on departmental stock were:

- Department B 1,000
- Department C 2,000

Prepare Departmental Trading and Profit & Loss Accounts for the year ending March 31, 2013 considering that closing stock of each department consists of only finished goods.

ACCOUNTING FOR BRANCHES INCLUDING FOREIGN BRANCHES

INTRODUCTION

BRANCH - Any establishment carrying on either the same or substantially the same activity as that carried on by head office of the company and located at a place or places different from the head office.
HEAD OFFICE - The principal place of business.

NEED TO LEARN BRANCH ACCOUNTS

1. Ascertain its performance
2. It is an integral part of the entity and hence its financial transactions have to be clubbed with head office.
3. Helps to obtain operational and financial control and decision making

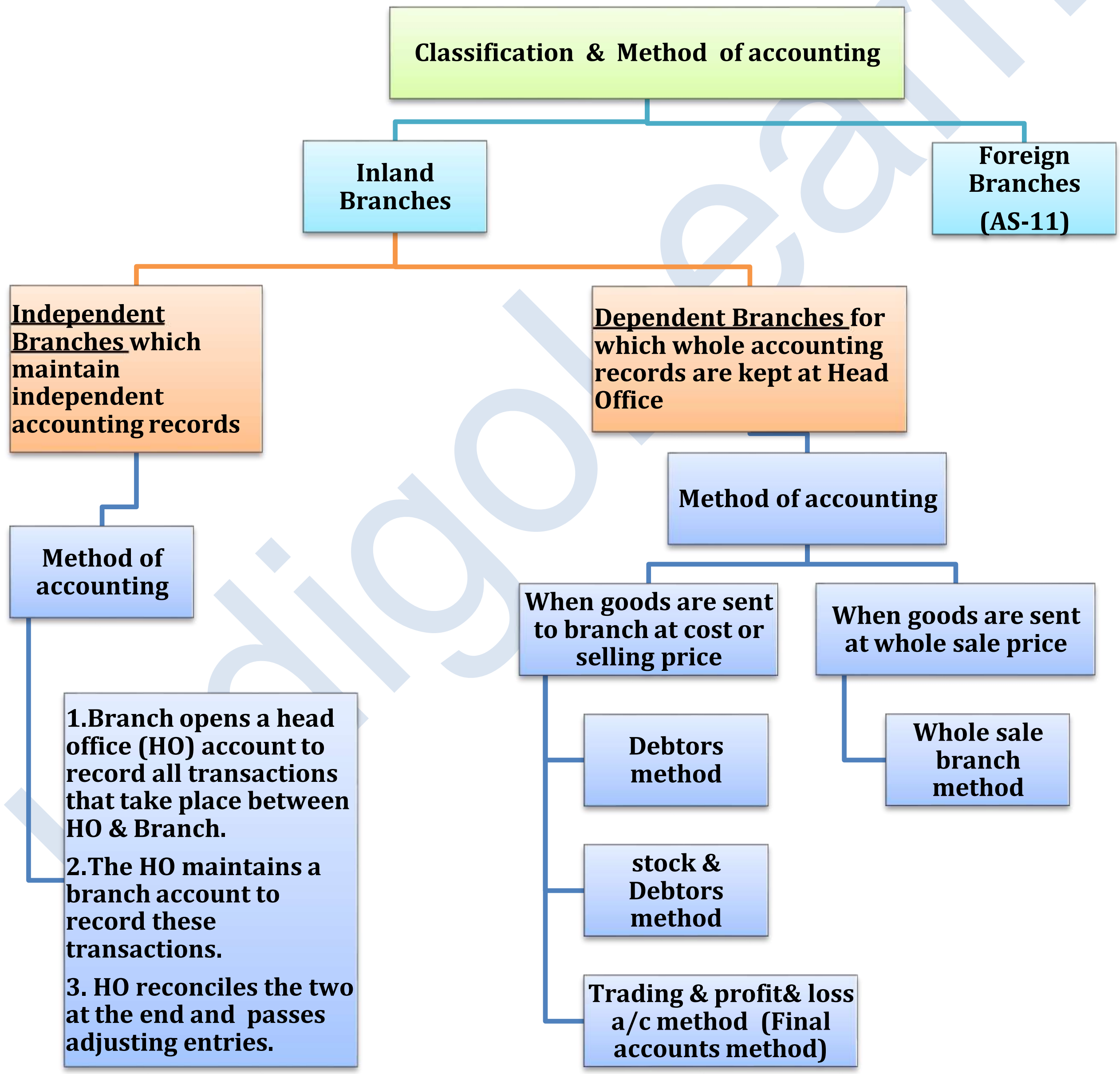
For finding out the trading results of branch, it is assumed that the branch is an entity separate from the head office.

DISTINCTION BETWEEN BRANCH ACCOUNTS AND DEPARTMENTAL ACCOUNTS

Basis	**Branch**	**Department**
Definition	Any establishment carrying on either the same or substantially the same activity as that carried on by head office and located at different places. For e.g. SBI and its branches.	An entity usually classified based on functionality which is part of the company. It need not be located at various places. For e.g. Production department, Purchase department etc.
Maintenance of accounts	Branch accounts may be maintained either at branch or at head office	Departmental accounts are maintained at one place only.
Allocation of common expenses	expenses in respect of each branch can be identified so no question of allocation	Common expenses are distributed among the departments concerned on some equitable basis considered suitable in the case.
Reconciliation	Reconciliation of head office and branch accounts is necessary in	No question of reconciliation

	case of independent branch accounting at the end of the accounting year.	
Conversion of foreign currency figures	At the time of finalization of accounts, conversion of figures of foreign branch is necessary.	No such conversion is needed

CLASSIFICATION OF BRANCHES & MEHTODS OF ACCOUNTING



DEPENDENT BRANCHES

- The business policies and the administration of a branch are wholly controlled by the head office
- Branch accounts, in such a case, are maintained at the head office out of reports and returns received from the branch
- Some examples of such branches are:
  - A branch set up merely for booking orders that are executed by the head office
  - A branch established at a commercial center for the sale of goods supplied by the head office, and under its direction all collections are made by the H.O
  - A branch for the retail sale of goods, supplied by the head office

- In first two cases, only a record of expenses incurred at the branch must be maintained.
- In case of retail branch, it sells goods supplied by the head office for cash or on credit to approved customers. Cash collected is deposited into a local bank to the credit of the HO and the HO issues cheques thereon for meeting the expenses of the branch. Further branch is provided imprest money. If, however, the branch also sells certain lines of goods, directly purchased by it, the branch retains a part of the sale proceeds to pay for the goods so purchased.

ACCOUNTING FOR DEPENDENT BRANCHES

★ **DEBTORS METHOD**

- suitable for small sized branches
- separate branch account is maintained for each branch to compute profit or loss made by each branch.
- For finding out the trading results of branch, it is assumed that the branch is an entity separate from the head office. On the basis, a Branch Account is stated in the head office books to which the price of goods or services provided, or expenses paid out are debited and correspondingly, the value of benefits and cash received from the branch are credited.

WHEN GOODS ARE INVOICED AT COST

Performa branch account (in the books of HO)

Particulars	Amount	Particulars	Amount
To Balance b/d Cash Stock		By Opening liabilities By Bank A/c (Cash remitted)	

Debtors			
Petty Cash		By Return to H.O.	
Fixed Assets		By Balance c/d	
Prepaid Expenses		Cash	
		Stock	
To Goods sent to Branch		Debtors	
		Petty Cash	
		Fixed Assets	
To Bank A/c		Prepaid Expenses	
(Exp paid by HO)		By Profit and Loss, A/c – Loss	
Salaries		(if debit side is greater)	
Rent			
Sundry Expenses			
To Closing liabilities			
To Profit & Loss A/c–Profit (if credit side is Greater)			

The following are not considered in the account-

- Cash and Credit sales made by branch.
- Expenses paid by branch (as they get adjusted with cash balances)
- Discount or allowances made to debtors
- Non-cash expenses like depreciation (also gets adjusted with opening and closing balance of assets)

The accuracy of the trading results as disclosed by the Branch Account, so maintained, if considered necessary, can be proved by preparing a Memorandum Branch Trading and Profit & Loss Account, in the usual way, from the balances of various items of income and expenses contained in the Branch Account.

WHEN GOODS ARE INVOICED AT SELLING PRICE

- The value of unsold stock at the branch at the end of the year needs to be adjusted with the following, before it is incorporated in the HO accounts:
  - The change in selling price.
  - The amount of anticipatory profit included in the value of unsold stock with the branch at the close of the year will have to be eliminated before the accounts of the branch are incorporated with that of the head office. This will be done by creating a reserve.
  - Physical losses of stock due to either pilferage or wastages which may have

occurred during the year. This is done by debiting the cost of the goods to Goods Lost Account and the amount of loading (included in the lost goods), to the Branch Adjustment Account.

- The stock reserve portion has to be reversed from all the components – Opening balance, goods sent to Branch, goods returned, and closing stock. And thus, two additional accounts must be prepared:
  - The Goods Sent to Branch Account; and
  - The Stock Reserve Account.

Journal entries	
Goods sent to the Branch at selling price Branch A/c To Goods sent to Branch A/c	 Dr.
Adjustment of loading (difference between the cost and selling price) Goods sent to branch A/c To Branch A/c	 Dr.
Goods returned to HO at selling price Goods sent to branch A/c To Branch A/c	 Dr.
Adjustment of loading in respect of goods returned Branch A/c To Goods sent to Branch A/c	 Dr.
Loading included in the opening stock (to be reduced) Stock Reserve A/c To Branch A/c	 Dr.
Closing stock at selling price Branch Stock A/c To Branch A/c	 Dr.
Loading included in closing stock to reduce it to cost Branch A/c To Stock reserve A/c	 Dr.
Notes: - In respect of closing stock at branch for the purpose of disclosure in the Balance Sheet, the credit balance in the 'Stock Reserve Account' at the end of the year will be deducted from the value of the closing stock, so as to reduce it to close; it will be carried forward as a separate balance to the following year, for being transferred to the credit of the Branch A/c	

★ STOCK AND DEBTORS METHOD

- ❖ Useful when it is desired to exercise a more detailed control over the working of a branch.
- ❖ According to this method, the following accounts are maintained by the H O:

Account	Purpose and Treatment
Branch Stock Account (or Branch Trading Account)	Ascertainment of shortage or surplus i.e. Gross profit or loss. The balance is transferred to branch P&L. Closing stock is credited at cost.
Branch Profit and Loss Account	Calculation of net profit or loss. All expenses of branch (whether paid by Branch or paid by HO or non-cash expenses) are debited in this account. The balance is transferred to HO P&L account.
Branch Debtors account	Ascertainment of closing balance of debtors. This is prepared only if goods are sold on credit
Branch expense account	Ascertainment of total expenses incurred This is optional. Transfer the balance to Branch P&L account.
Goods sent to branch account	Ascertainment of cost of goods sent to branch. The credit balance in this Account is afterwards transferred to the Head Office Purchase Account or Trading Account
Branch cash account	Ascertainment of cash balance. This is prepared if the branch has purchased goods locally and incurred expenses out of its cash collections.
Branch Assets account	Ascertainment of Assets balance. Optional, If the branch has spent on it.
Branch Adjustment account (This is prepared, along with other accounts, only when goods are sent at selling price)	Ascertain stock reserve/unrealized profit. We eliminate the profit element from each and every item of branch stock account except sales and sales returns. This is done by crediting this account. The balance in this account, at the end of year consists of Gross Profit earned on sale by the branch. Hence, it will be transferred to the Branch Profit and Loss Account.

WHEN GOODS ARE INVOICED AT COST

Journal entries	
Cost of goods sent to the Branch Branch Stock A/c To Goods sent to Branch A/c	 Dr.
Remittances for expenses Branch Cash A/c To (HO) Cash A/c	 Dr.
Any assets (e.g. furniture) provided by H.O. Branch Asset (Furniture) A/c To (HO) Cash A/c or To Vendor's A/c or To (HO) Furniture A/c	 Dr.
Cost of goods returned by the branch Goods sent to Branch A/c To Branch Stock A/c	 Dr.
Cash Sales / Credit Sales at the Branch Branch Cash A/c or Branch Debtors A/c To Branch Stock A/c	 Dr. Dr.
Return of goods by debtors to the Branch Branch Stock A/c To Branch Debtors A/c	 Dr.
Cash paid by debtors Branch Cash A/c To Branch Debtors A/c	 Dr.
Discount & allowance to debtors, bad debts Branch Expenses A/c To Branch Debtors A/c	 Dr.
Remittances to H.O. (H.O.) Cash A/c To Branch Cash A/c	 Dr.

Expenses met by H.O. Branch Expenses A/c To (HO) Cash A/c	 Dr.
Notes: ➢ Credit the Branch Stock Account with the value of closing stock at cost. It will be carried down as opening balance (debit) for the next accounting period. The Balance of the Branch Stock Account, (after adjustment therein the value of closing stock), if in credit, will represent the gross profit on sales and vice versa.	

WHEN GOODS ARE INVOICED AT SELLING PRICE

❖ The following points should be kept in mind under this method:

Journal entries	
Goods sent to the Branch at selling price Branch stock A/c (@Selling price) To Goods sent to Branch A/c (@cost) To Branch adjustment A/c (Loading)	 Dr.
Goods returned to HO at selling price Goods sent to branch A/c (@cost) Branch Adjustment A/c (Loading) To Branch Stock A/c (@Selling price)	 Dr. Dr.
Cash sales at the Branch Bank / Cash A/c To Branch stock A/c	 Dr.
Credit Sales at the Branch Branch Debtors A/c To Branch stock A/c	 Dr.
Goods returned to Branch by customers Branch Stock A/c To Branch Debtors A/c (@Selling price)	 Dr.
Goods lost in transit or stolen Goods lost in transit / Goods stolen A/c (@Cost) Branch Adjustment A/c (Loading) To Branch Stock A/c	 Dr. Dr.
Rebates and allowances allowed to customers Branch Adjustment A/c To Branch stock A/c (in case of cash sales) To Branch debtor's A/c (in case of credit sales)	 Dr.

Notes:

- The value of stock actually held at the branch is either more or less than the balance of the Branch Stock Account. Branch Stock Account is increased or reduced by debit or credit to Goods Lost Account (at cost price of goods) and Branch Adjustment Account (with the loading).
- Closing stock - The discrepancy in the amount of balance in the Branch Stock Account and the value of stock actually in hand, valued at sale price, may be the result of one or more of the under-mentioned factors:
  - An error in applying the percentage of loading.
  - Goods having been sold either below or above the established selling price.
  - A Commission to adjust returns or allowances.
  - Physical loss of stock due to natural causes or pilferage.
  - Errors in Stock-taking.
- The above-mentioned losses must be accounted at cost and the profit element in them is debited to branch adjustment account.
- ***An alternate method*** - Where the gross profit of each branch is not required to be ascertained separately, although the selling price is uniform, the amount of goods sent to the branch is recorded only in two accounts namely - Branch Stock Account and Goods Sent to Branch A/c.
  In this method, at the end of the year the Branch Stock Account is closed by transfer of the balance representing the value of closing stock, at sale price, to the Goods Sent to Branch Account. This has the effect of altogether eliminating from the books the value of stock at the branch. The balance of Goods sent to Branch Account is afterwards transferred to the Trading Account representing the net sale price of goods sold at the branch. In that case, the value of closing stock at the branch at cost will be subsequently introduced in the Trading Account together with that of closing stock at the head office.

★ BRANCH TRADING AND PROFIT AND LOSS ACCOUNT (FINAL ACCOUNTS METHOD)

- In this method, Trading and P&L accounts are prepared considering each branch as a separate entity.
- Easy to prepare and understand.
- Gives complete information of all transactions which are ignored in the other methods.

WHEN GOODS ARE INVOICED AT COST PRICE

- Branch Trading and P&L account is merely a memorandum account and therefore, the entries made there in do does not have double entry effect.

- ❖ Gross Profit and Net Profit earned by the branch are ascertainable.
- ❖ Evaluating the performance of the branch is very much easier

WHEN GOODS ARE INVOICED AT SELLING PRICE

- ❖ All items of memorandum Branch Trading and Profit and Loss Account are to be converted into cost price.
- ❖ Other points will remain same as mentioned above if goods are invoiced at cost.

★ WHOLESALE BRANCH METHOD

WHEN GOODS INVOICED AT WHOLESALE PRICE TO RETAIL BRANCHES

- ❖ Under this method, the Head Office (particularly, the manufacturing concern) supplies goods to its retail branches at wholesale price which is cost plus wholesale profit.
- ❖ Profit attributable to such branches = Sale proceeds - wholesale price of the goods sold.
- ❖ The accounts prepared maintained are:
  - ➢ Branch stock account / Branch Trading account
  - ➢ Branch P&L account
  - ➢ Stock reserve account

Proforma Branch stock account

Particulars	Amount	Particulars	Amount
To Opening stock	xxx	By Sales	xxx
To Goods sent to branch	xxx	By Goods lost in transit	xxx
To Gross profit	xxx	By Closing stock	xxx
	xxx		xxx

Note:

- ➢ All the above amounts are in wholesale price, except sales which is at retail price.
- ➢ Since the closing stock at the branch is valued at wholesale price, a stock reserve is created, equal to the difference between its wholesale price and its cost (to HO) by debiting the amount in the HO P&L A/c. This Stock Reserve is carried down to the next year and then transferred to the credit of the HO P&L A/c.

Branch P&L account

Particulars	Amount	Particulars	Amount
To Goods lost in transit To Branch expenses To Net profit transferred	xxx xxx xxx	By Gross profit	xxx xxx
	xxx		xxx

Stock reserve A/c

Particulars	Amount	Particulars	Amount
To HO P&L A/c (transferred)	xxx	By Balance b/d (Loading on opening stock)	Xxx
To Balance c/d (stock reserve required)	xxx	By HO P&L A/c (Loading on Closing stock)	Xxx
	xxx		Xxx

ACCOUNTING FOR INDEPENDENT BRANCHES

- When the size of the business is big, the branch maintains complete records of its transactions. These branches are called independent branches.
- Accounting happens as follows:
  1) Branch maintains its entire books of account under double entry system.
  2) Branch opens in its books a Head Office account to record all transactions that take place between Head Office and branch. The Head Office maintains a Branch account to record these transactions.
     The branch A/c and the Head office A/c are converse of each other.
  3) Branch prepares its Trial Balance, Trading and profit and loss Account at the end of the accounting period and sends copies of these statements to Head Office for incorporation.
  4) Inter-branch transactions are usually adjusted as if they were entered only with the head office.
  5) After receiving the final statements from branch, Head Office reconciles between the two – Branch account in Head Office books and Head Office account in Branch books.
     A consolidated reconciliation statement is prepared passing necessary rectification entries (either in the HO books or Branch books or both as the case may be)
     Some common reasons for difference are:
     - Goods in transit (either sent by HO or returned by Branch)
     - Cash in transit (either remitted by HO or by branch)
     - Cash directly collected by HO from Branch debtors
     - Payment made directly to the vendors by HO on behalf of branch.

6) Head office passes necessary journal entries to incorporate branch trial balance in its books.
7) The result of these adjustments will be that so far as the Head Office is concerned, the branch will be looked upon either as a debtor or creditor. As a debtor if the amount of its assets is in excess of its liabilities and as a creditor if the position is reverse.
8) when accounts of the branch and head office are consolidated both the Branch and Head Office Accounts will be eliminated.
9) <u>Incorporation of branch balance in head office books – 2 Options exists</u>
    a. <u>Prepare separate P&L Account and Balance Sheet of the branch and the HO</u>.
        - The amount of profit or loss shown by the Branch P&L A/c only will be transferred to Head office Account in the branch books and a converse entry will be passed in the Head Office books.
        - The branch Balance Sheet would show the amount advanced by the head office to it, as capital. In the head office Balance Sheet, the same amount would be shown as an advance to the branch.
    b. <u>Prepare consolidated statement of account of both branch and head office.</u>
        - Individual balances of all the revenue accounts would be separately transferred to the Head Office Account by debit or credit in the branch books and the converse entries would be passed in the head office books.
        - Transfer the balance of assets and liabilities of the branch to the head office and pass converse entries in the books of HO.
        - At the beginning of next year, the entries are reversed.
10) If it is desired that profitability of the branch should be kept secret from the branch staff, the head office would hold back some key information from the branch, e.g., amount of opening stock, cost of goods sent to the branch, etc. The head office, in such a case would maintain a record of goods sent to the branch by passing the entry:

    Goods Supplied to the Branch Account Dr.

        To Purchases Account

    The value of the closing stock will also be adjusted only in head office books. In such a
    case, for closing its books at the end of the year, the branch will simply transfer various revenue accounts to the head office without drawing up a Trading and Profit
    & Loss Account. The HO will construct the Trading and Profit & Loss Account of the
    branch.

Transactions	**Head office Books**	**Branch Books**

Dispatch of goods to branch by H.O.	Branch A/c Dr. To Good sent to Branch A/c	Goods received from H.O. A/c Dr. To Head Office A/c
When goods are returned by branch	Goods sent to Branch A/c Dr. To Branch A/c	Head Office A/c Dr. To Goods received from H.O. A/c
Branch Expenses paid by branch	No Entry	Expenses A/c Dr. To Bank or Cash A/c
Branch Expenses paid by HO	Branch A/c Dr. To Bank or cash	Expenses A/c Dr. To Head Office A/c
Outside purchases made by branch	No Entry	Purchases A/c Dr. To Bank A/c(or) To Creditors A/c
Sales effected by branch	No Entry	Cash or Debtors A/c Dr. To Sales
Collection from Branch debtors received by HO	Cash or Bank A/c Dr. To Branch A/c	Head office A/c Dr. To Sundry Debtors A/c
Payment by H.O. for purchase made by Branch	Branch A/c Dr. To Bank A/c	Purchases/Creditors A/c Dr. To Head Office
Purchase of Asset by branch	No Entry	Sundry Assets A/c Dr. To Bank A/c (or) To Liability A/c
Asset purchased by the Branch, but Asset A/c retained at H.O. books	Branch Asset A/c Dr. To Branch A/c	Head office Dr. To Bank (or) Liability
Depreciation on above	Branch A/c Dr. To Branch Asset	Depreciation A/c Dr. To Head Office A/c
Remittance of funds by HO to branch	Branch A/c Dr. To Bank	Bank A/c Dr. To Head Office
Remittance of funds by Branch to H. O	Reverse the above entry	Reverse the above entry
Goods sent by HO are in transit	No entry	Goods in transit A/c Dr. To Head office A/c

Allocation of expenses by HO	Branch A/c Dr. To expense A/c	Expense A/c Dr. To Head office A/c
Transfer of goods from one branch to another branch	Recipient branch A/c Dr. To Supplying branch	Supplying branch: Head Office A/c Dr. To Goods received from Head Office A/c Recipient branch: Goods received from HO A/c Dr. To Head Office A/c

FOREIGN BRANCHES

- Foreign branches generally maintain independent and complete record of business transacted by them in currency of the country in which they operate.
- Thus, problems of incorporating balances of foreign branches relate mainly to translation of foreign currency into Indian rupees. This is because exchange rate of Indian rupee is not stable in relation to foreign currencies due to international demand and supply effects on various currencies.
- The accounting principles which apply to inland branches also apply to a foreign branch after converting the trial balance of the foreign branch in the Indian currency.

Important terms

Monetary items

Money held and assets and liabilities to be received or paid in fixed or determinable amounts of money. Cash, receivables and payables are examples of monetary items.

Non-monetary items

Assets and liabilities other than monetary items. Fixed assets, investments in equity shares, inventories are examples of non-monetary assets.

Integral Foreign Operation (IFO)

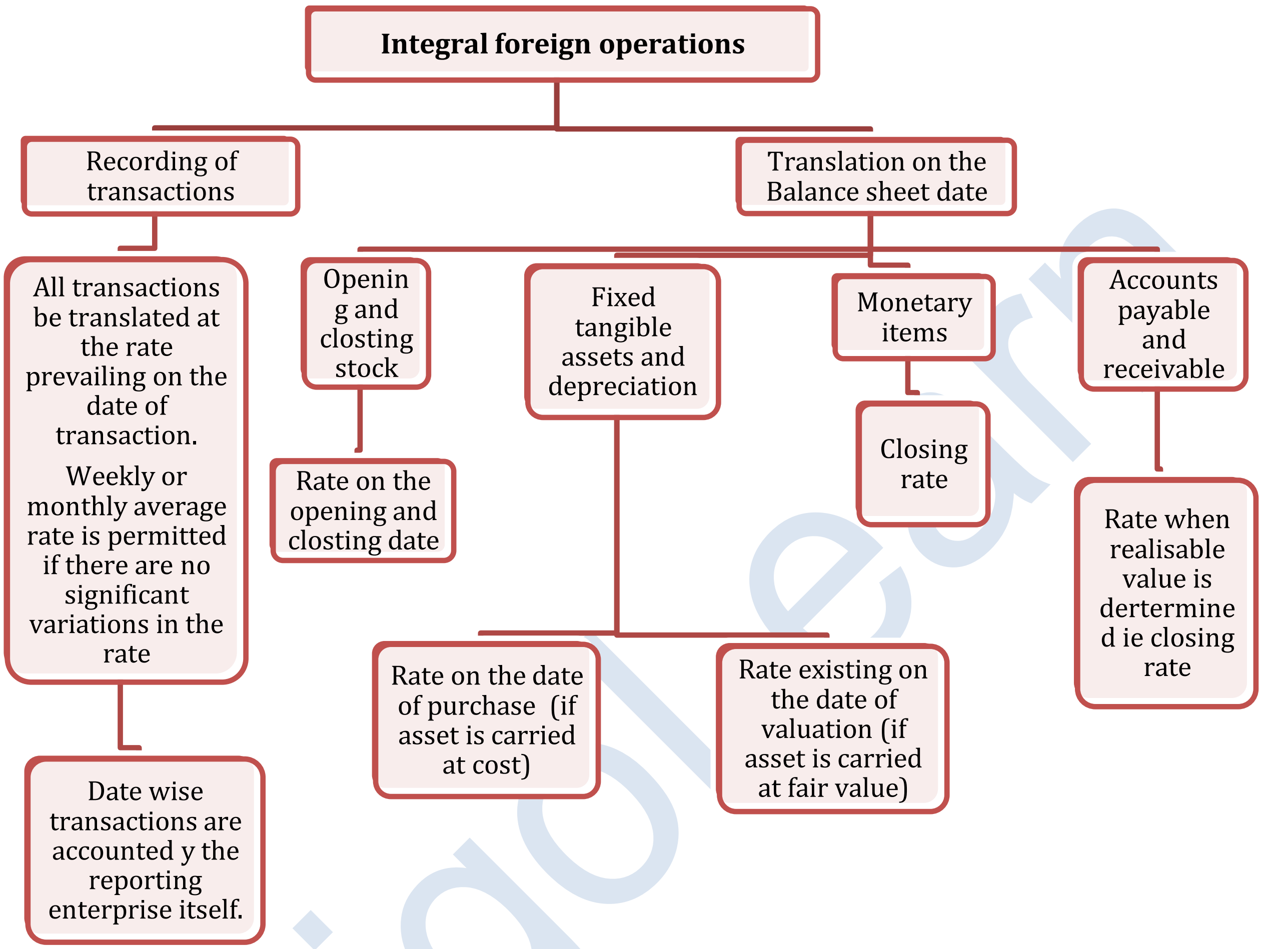
It is a foreign operation, the activities of which are an integral part of those of the reporting enterprise. The business of IFO is carried on as if it were an extension of the reporting enterprise's operations. For example, sale of goods imported from the reporting enterprise and remittance of proceeds to the reporting enterprise.

Non-Integral Foreign Operation (NFO)

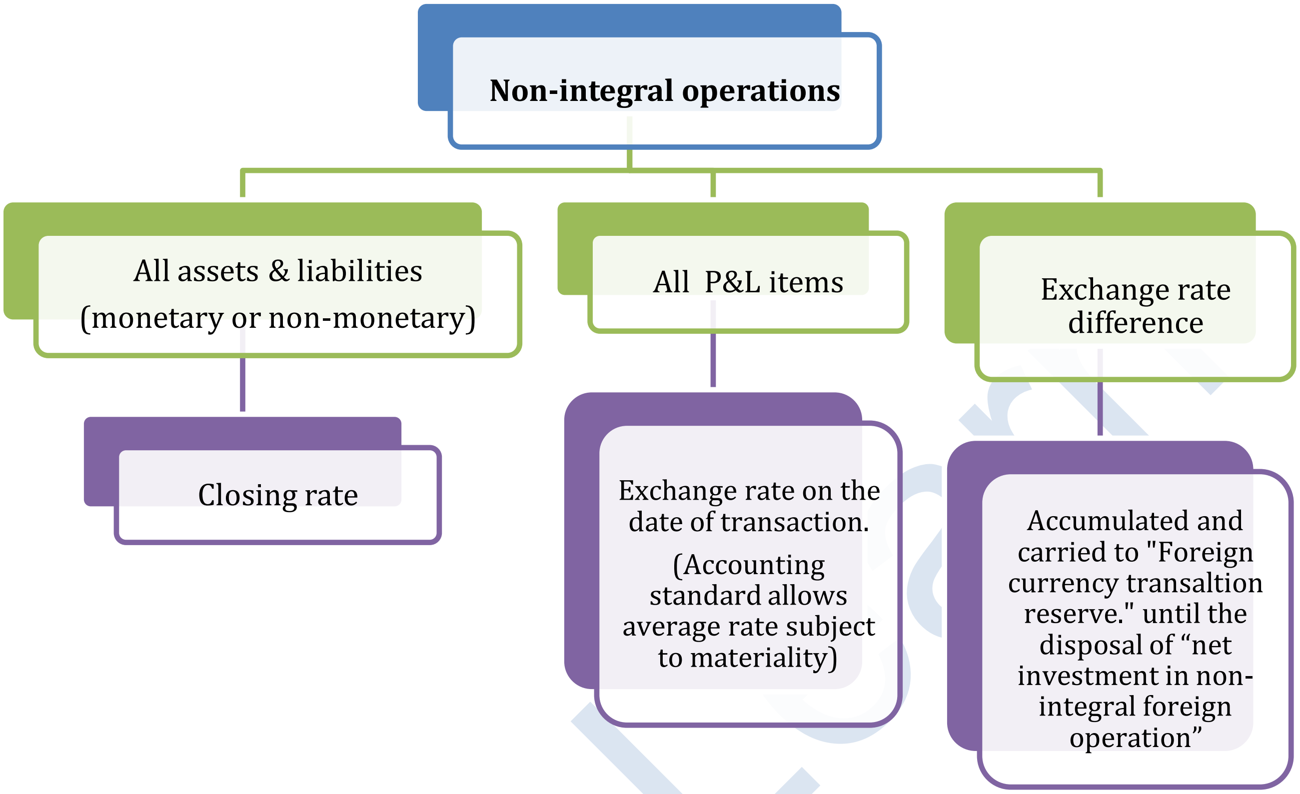
It is a foreign operation that is not an Integral Foreign Operation. The business of a NFO is carried on in a substantially independent way by accumulating cash and other monetary items, incurring expenses, generating income and arranging borrowing in its local currency. An NFO may also enter into transactions in foreign currencies, including transactions in the reporting currency

- If the Question is silent always assume it is integral otherwise it will be specifically mentioned.
- The following are the indicators of Non- Integral Foreign Operation
  - Control by reporting enterprises - While the reporting enterprise may control the foreign operation, the activities of foreign operation are carried independently without much dependence on reporting enterprise.
  - Transactions with the reporting enterprises are not a high proportion of the foreign operation's activities.
  - Activities of foreign operation are mainly financed by its operations or from local borrowings.
  - Foreign operation sales are mainly in currencies other than reporting currency.
  - Day-to-day cash flow of the reporting enterprises is independent of the foreign enterprises cash flows.
- Subsidiary, Associates, joint ventures and branches classified as independent for the purpose of accounting are non-integral foreign operation.

TECHNIQUES FOR FOREIGN CURRENCY TRANSLATION



Integral foreign operations - After converting all the items of Trial balance as per above norms the difference will represent forex gain or loss which is transferred to P&L



CHANGE IN CLASSIFICATION

When there is a change in classification, accounting treatment is as under-

- **Integral to Non-Integral**
  - Translation procedure applicable to non-integral shall be followed from the date of change.
  - Exchange difference arising on the translation of non-monetary assets at the date of re-classification is accumulated in foreign currency translation reserve.

- **Non-Integral to Integral**
  - Translation procedure as applicable to integral should be applied from the date of change.
  - Translated amount of non-monetary items at the date of change is treated as historical cost.
  - Exchange difference lying in foreign currency translation reserve is not to be recognized as income or expense till the disposal of the operation even if the foreign operation becomes integral.

Illustrations

ILLUSTRATIONS

Illustration - 1

Buckingham Bros, Bombay have a branch at Nagpur. They send goods at cost to their branch at Nagpur. However, direct purchases are also made by the branch for which payments are made at head office. All the daily collections are transferred from the branch to the head office.

From the following, prepare Nagpur branch account in the books of head office by

Debtors method:

Particulars	Amount (Rs.)	Particulars	Amount (Rs.)
Opening balance (1-1-20X1) Imprest Cash	2,000	Bad Debts	1,000
Sundry Debtors	25,000	Discount to Customers	2,000
Stock: Transferred from H.O.	24,000	Remittances to H.O. (recd. by H.O.)	1,65,000
Direct Purchases	16,000	Remittances to H.O. (not recd. by H.O. so far)	5,000
Cash Sales	45,000	Branch Exp. directly paid by H.O.	30,000
Credit Sales	1,30,000	Closing Balance (31-12-20X1) Stock:	10,000
Direct Purchases	45,000	Direct Purchase Transfer from H.O.	15,000
Returns from Customers	3,000	Debtors	?
Goods sent to branch from H.O.	60,000	Imprest Cash	?
Transfer from H.O. for Petty Cash expenses	4,000	Petty Cash expenses	4,000

Illustration - 2

The Bombay Traders invoiced goods to its Delhi branch at cost. Head Office paid all the branch expenses from its bank account, except petty cash expenses which were met by the Branch. All the cash collected by the branch was banked on the same day to the credit of the Head Office. The following is a summary of the transactions entered at the branch during the year ended December 31, 20X1.

Particulars	Amount (Rs.)	Particulars	Amount (Rs.)
Balances as on 1.1.20X1:		Bad Debts	600
Stock	7,000	Goods returned by customers	500
Debtors	12,600	Salaries & Wages	6,200
Petty Cash	200	Rent & rates	1,200
Goods sent from H.O.	26,000	Sundry Expenses	8,00
Goods returned to H.O.	1,000	Cash received (from Sundry Debtors)	2,800
Cash sales	17,500	Balances as on 31.12.20X1:	
Credit sales	28,400	Stock	6,500
Allowances to customers	200	Debtors	9,800
Discount to customers	1,400	Petty Cash	100

Prepare:

(a) Branch Account (Debtors Method),

(b) Branch Stock Account, Branch Profit & Loss Account, Branch Debtors and Branch Expenses Account by adopting the Stock and Debtors Method and

(c) Branch Trading and Profit & Loss Account to prove the results as disclosed by the Branch Accounts

Illustration - 3

Harrison of Chennai has a branch at New Delhi to which goods are sent @ 20% above cost. The branch makes both cash and credit sales. Branch expenses are met partly from H.O. and partly by the branch. The statement of expenses incurred by the branch every month is sent to head office for recording. Following further details are given for the year ended 31st December, 20X1:

Particulars	Amount (Rs.)
Cost of goods sent to Branch at cost	2,00,000
Goods received by Branch till 31-12-20X1 at invoice price	2,20,000
Credit Sales for the year @ invoice price	1,65,000
Cash Sales for the year @ invoice price	59,000
Cash Remitted to head office	2,22,500
Expenses paid by H.O.	12,000

Bad Debts written off	750

Particulars	Amount (Rs.)	Amount (Rs.)
Balances as on	1-1-20X1	31-12-20X1
Stock	25,000 (Cost)	28,000 (invoice price)
Debtors	32,750	26,000
Cash in Hand	5,000	2,500

Show necessary ledger accounts in the books of the head office and determine the Profit and Loss of the Branch for the year ended 31st December, 20X1.

Illustration - 4

Following is the information of the Jammu branch of Best New Delhi for the year ending 31st March, 20X2 from the following:

1. Goods are invoiced to the branch at cost plus 20%.
2. The sale price is cost plus 50%.
3. Other information:

Particulars	Amount (Rs.)
Stock as on 01.04.20X1(invoice price)	2,20,000
Goods sent during the year (invoice price)	11,00,000
Sales during the year	12,00,000
Expenses incurred at the branch	45,000

Ascertain

1. the profit earned by the branch during the year.
2. branch stock reserve in respect of unrealized profit.

Illustration - 5

Sell Well who carried on a retail business opened a branch X on January 1st, 20X1 where all sales were on credit basis. All goods required by the branch were supplied from the Head Office and were invoiced to the branch at 10% above cost.

The following were the transactions:

Particulars	Jan. 20X1 Amount (Rs.)	Feb. 20X1 Amount (Rs.)	March 20X1 Amount (Rs.)

Goods sent to Branch (Purchase Price)	40,000	50,000	60,000
Sales as shown by the branch monthly report	38,000	42,000	55,000
Cash received from Debtors and remitted to H.O.	20,000	51,000	35,000
Returns to H.O. (Invoice price to Branch)	1,200	600	2,400

The stock of goods held by the branch on March 31, 20X1 amounted to Rs. 53,400 at invoice to branch.

Record these transactions in the Head Office books, showing balances as on 31st March, 20X1 and the branch gross profit for the three months ended on that date.

All workings should form part of your solution.

Illustration - 6

Hindustan Industries Mumbai has a branch in Cochin to which office goods are invoiced at cost plus 25%. The branch sells both for cash and on credit. Branch Expenses are paid direct from head office, and the Branch must remit all cash received into the Head Office Bank Account.

From the following details, relating to calendar year 20X1, prepare the accounts in the Head Office Ledger and ascertain the Branch Profit. Branch does not maintain any books of account, but sends weekly returns to the Head Office:

Particulars	Amount (Rs.)
Goods received from Head Office at invoice price	6,00,000
Returns to Head Office at invoice price	12,000
Stock at Cochin as on 1st Jan., 20X1	60,000
Sales in the year - Cash	2,00,000
Credit	3,60,000

Sundry Debtors at Cochin as on 1st Jan. 20X1	72,000
Cash received from Debtors	3,20,000
Discount allowed to Debtors	6,000
Bad debts in the year	4,000
Sales returns at Cochin Branch	8,000
Rent, Rates, Taxes at Branch	18,000
Salaries, Wages, Bonus at Branch	60,000
Office Expenses	6,000
Stock at Branch on 31st Dec. 20X1 at invoice price	1,20,000

Prepare Branch accounts in books of head office by Stock and debtors' method.

Illustration - 7

M/s Rahul operates a number of retail outlets to which goods are invoiced at wholesale price which is cost plus 25%. These outlets sell the goods at the retail price which is wholesale price plus 20%.

Following is the information regarding one of the outlets for the year ended 31.3.20X2:

Particulars	Amount (Rs.)
Stock at the outlet 1.4.20X1	30,000
Goods invoiced to the outlet during the year	3,24,000
Gross profit made by the outlet	60,000
Goods lost by fire	?
Expenses of the outlet for the year	20,000
Stock at the outlet 31.3.20X2	36,000

You are required to prepare the following accounts in the books of Rahul Limited for the year ended 31.3.20X2:

1. Outlet Stock Account.
2. Outlet Profit & Loss Account.
3. Stock Reserve Account.

Illustration - 8

Messrs Ramchand & Co., Hyderabad have a branch in Delhi. The Delhi Branch deals not only in the goods from Head Office but also buys some auxiliary goods and deals in them. They, however, do not prepare any Profit & Loss Account but close all accounts to the Head Office at the end of the year and open them afresh on the basis of advice from their Head Office.

The fixed assets accounts are also maintained at the Head Office. The goods from the Head Office are invoiced at selling prices to give a profit of 20 per cent on the sale price. The goods sent from the branch to Head Office are at cost.

From the following, prepare Branch Trading and Profit & Loss Account and Branch Assets Account in the Head Office Books.

Debit	Amount (Rs.)	Credit	Amount (Rs.)
Head office opening balance on 1-1-16	15,000	Sales	1,00,000
Goods from H.O.	50,000	Goods to H.O.	3,000
Purchases	20,000	Head Office Current A/c	15,000
Opening Stock		Sundry Creditors	3,000
(H.O. goods at invoice prices)	4,000		
Opening Stock of other goods	500		
Salaries	7,000		
Rent	3,000		
Office expenditure	2,000		
Cash on Hand	500		
Cash at Bank	4,000		
Sundry Debtors	15,000		
	1,21,000		**1,21,000**

The Branch balances as on 1st January, 20X1, were as under: Furniture Rs. 5,000; Sundry Debtors Rs. 9,500; Cash Rs. 1,000, Creditors Rs. 30,000. The closing stock at branch of the head office goods at invoice price is Rs. 3,000 and that of purchased goods at cost is Rs. 1,000. Depreciation is to be provided at 10 % on branch assets.

Illustration - 9

Ring Bell Ltd. Delhi has a Branch at Bombay where a separate set of books is used. The following is the trial balance extracted on 31st December, 20X1.

Head Office Trial Balance

Particulars	Debit (Rs.)	Credit (Rs.)
Share Capital (Authorised: 10,000 Equity Shares of Rs. 100 each):		

Issued: 8,000 Equity Shares		8,00,000
Profit & Loss Account - 1-1-20X1		25,310
General Reserve		1,00,000
Fixed Assets	5,30,000	
Stock	2,22,470	
Debtors and Creditors	50,500	21,900
Profit for 20X1		52,200
Cash Balance	62,730	
Branch Current Account	1,33,710	
	9,99,410	**9,99,410**

Branch Trial Balance

Particulars	**Debit (Rs.)**	**Credit (Rs.)**
PPE (Property, plant & Equipment)	95,000	
Profit for 20X1		31,700
Stock	50,460	
Debtors and Creditors	19,100	10,400
Cash Balance	6,550	
Head Office Current Account		1,29,010
	1,71,110	**1,71,110**

The difference between the balances of the Current Account in the two sets of books is accounted for as follows:

1. Cash remitted by the Branch on 31st December, 20X1, but received by the Head

Office on 1st January 20X2 – Rs. 3,000.

2. Stock stolen in transit from Head Office and charged to Branch by the Head Office, but not credited to Head Office in the Branch books as the Branch Manager declined to admit any liability (not covered by insurance) – Rs. 1,700.

Give the Branch Current Account in Head Office books after incorporating Branch Trial Balance through journal.

Illustration - 10

KP manufactures a range of goods which it sells to wholesale customers only from its head office. In addition, the H.O. transfers goods to a newly opened branch at factory cost plus 15%.

The branch then sells these goods to the general public on only cash basis. The selling price to wholesale customers is designed to give a factory profit which amounts to 30% of the sales value.

The selling price to the general public is designed to give a gross margin (i.e., selling price less cost of goods from H.O.) of 30% of the sales value.

KP operates from rented premises and leases all other types of fixed assets. The rent and hire charges for these are included in the overhead costs shown in the trial balances.

From the information given below, you are required to prepare for the year ended 31st Dec., 20X1 in columnar form.

1. A Profit & Loss account for (i) H.O. (ii) the branch (iii) the entire business.
2. Balance Sheet as on 31st Dec., 20X1 for the entire business.

Particulars	**Head Office**		**Branch Office**	
	Debit (Rs.)	Credit (Rs.)	Debit (Rs.)	Credit (Rs.)
Raw materials purchased	35,000			
Direct wages	1,08,500			
Factory overheads	39,000			
Stock on 1-1-20X1				
Raw materials	1,800			
Finished goods	13,000		9,200	
Debtors	37,000			
Cash	22,000		1,000	
Administrative Salaries	13,900		4,000	
Salesmen Salaries	22,500		6,200	
Other administrative & selling overheads	12,500		2,300	
Inter-unit accounts	5,000			2,000
Capital		50,000		
Sundry Creditors		13,000		
Provision for unrealized profit in stock		1,200		
Sales		2,00,000		65,200
Goods sent to Branch		46,000		
Goods received from H.O.			44,500	
	3,10,200	**3,10,200**	**67,200**	**67,200**

1. On 28th Dec., 20X1 the branch remitted Rs.1,500 to the H.O. and this has not yet been recorded in the H.O. books. Also, on the same date, the H.O. dispatched goods to the branch invoiced at Rs. 1,500 and these too have not yet been entered the branch books. It is the company's policy to adjust items in transit in the books of the recipient.
2. The stock of raw materials held at the H.O. on 31st Dec., 20X1 was valued at Rs. 2,300.

3. You are advised that:
    a. there were no stock losses incurred at the H.O. or at the branch.
    b. it is KP's practice to value finished goods stock at the H.O. at factory cost.
    c. there was no opening or closing stock of work-in-progress.
    d. Branch employees are entitled to a bonus of Rs.156 under a bilateral agreement.

Illustration - 11

On 31st December, 20X2 the following balances appeared in the books of Chennai Branch of an English firm having its HO office in New York:

Particulars	Amount (Rs.)	Amount (Rs.)
Stock on 1st Jan., 20X2	2,34,000	
Purchases and Sales	15,62,500	23,43,750
Debtors and Creditors	7,65,000	5,10,000
Bills Receivable and Payable	2,04,000	1,78,500
Salaries and Wages	1,00,000	-
Rent, Rates and Taxes	1,06,250	-
Furniture	91,000	-
Bank A/c	5,68,650	
New York Account	-	5,99,150
	36,31,400	**36,31,400**

Stock on 31st December, 20X2 was Rs. 6,37,500.

Branch account in New York books showed a debit balance of \$ 13,400 on 31st December, 20X2 and Furniture appeared in the Head Office books at \$ 1,750.

The rate of exchange for 1 \$ on 31st December, 20X1 was Rs. 52 and on 31st December, 20X2 was Rs. 51. The average rate for the year was Rs. 50.

Prepare in the Head Office books the Profit and Loss A/c and the Balance Sheet of the Branch assuming integral foreign operation.

Illustration - 12

S & M Ltd., Bombay, have a branch in Sydney, Australia. Sydney branch is an integral foreign operation of S & M Ltd.

At the end of 31st March, 20X2, the following ledger balances have been extracted from the books of the Bombay Office and the Sydney Office:

Particulars	Bombay Rupees (Rs.000)		Sydney Austr. Dollars ('000)	
	Debit	**Credit**	**Debit**	**Credit**
Share Capital	-	2,000	-	-
Reserves & Surplus	-	1,000	-	-
Land	500	-	-	-
Buildings (Cost)	1,000	-	-	-
Buildings Dep. Reserve	-	200	-	-
Plant & Machinery (Cost)	2,500	-	200	-
Plant & Machinery Dep. Reserve	-	600	-	130
Debtors / Creditors	280	200	60	30
Stock (1.4.20X1)	100	-	20	-
Branch Stock Reserve	-	4	-	-
Cash & Bank Balances	10	-	10	-
Purchases / Sales	240	520	20	123
Goods sent to Branch	-	100	5	-
Managing Director's salary	30	-	-	-
Wages & Salaries	75	-	45	-
Rent	-	-	12	-
Office Expenses	25	-	18	-
Commission Receipts	-	256	-	100
Branch / H.O. Current A/c	120	-	-	7
	4,880	**4,880**	**390**	**390**

The following information is also available:

Stock as at 31.3.20X2: Bombay Rs. 1,50,000; Sydney A $ 3,125

You are required to convert the Sydney Branch Trial Balance into rupees;

use the following rates of exchange:

Particulars	1 A $ = Rs.	Applicability
Opening rate	20	Opening stock
Closing rate	24	Closing stock; all monetary items
Average rate	22	Purchases; Sales; Etc.,
For Fixed Assets	18	Fixed assets

Illustration - 13

M/s Carlin has head office at New York (U.S.A.) and branch at Mumbai (India). Mumbai branch is an integral foreign operation of Carlin & Co.

Mumbai branch furnishes you with its trial balance as on 31st March, 20X2 and the additional information given thereafter:

Particulars	Dr.	Cr.
	Rupees in thousands	
Stock on 1st April, 20X1	300	-
Purchases and sales	800	1,200
Sundry Debtors and creditors	400	300
Bills of exchange	120	240
Wages and salaries	560	-
Rent, rates and taxes	360	-
Sundry charges	160	-
Computers	240	
Bank balance	420	-
New York office a/c	-	1,620
	3,360	3,360

Additional information:

1. Computers were acquired from a remittance of US $ 6,000 received from New York head office and paid to the suppliers. Depreciate computers at 60% for the year.
2. Unsold stock of Mumbai branch was worth Rs. 4,20,000 on 31st March, 20X2.
3. The rates of exchange may be taken as follows:

(i) on 1.4.20X1 @ Rs. 40 per US $

(ii) on 31.3.20X2 @ Rs. 42 per US $

(iii) average exchange rate for the year @ Rs. 41 per US $

(iv) conversion in $ shall be made upto two decimal accuracy.

You are asked to prepare in US dollars the revenue statement for the year ended 31st March, 20X2 and the balance sheet as on that date of Mumbai branch as would appear in the books of New York head office of Carlin & Co. You are informed that Mumbai branch account showed a debit balance of US $ 39609.18 on 31.3.20X2 in New York books and there were no items pending reconciliation.

ACCOUNTS FROM INCOMPLETE RECORDS

INTRODUCTION

★ Very often small sole proprietorship and partnership businesses do not maintain double entry book keeping system. Sometimes they keep record of the cash transactions and credit transactions only. But at the end of the accounting period they want to know the performance and financial position of their businesses. So, it become imperative to complete the accounts from available incomplete records.

★ Accounts from incomplete records is also popularly known as ‘Single entry system’. Under this system the task of the accountant is to establish linkage among the available information and to finalize the accounts.

TYPES OF SINGLE-ENTRY SYSTEM

Types

- **Pure single entry**
  1. only personal accounts are maintained
  2. No information is available in respect of cash and bank balances, sales and purchases, etc.
  3. This method exists only on paper and has no practical application.
- **Simple single entry**
  1. In this, only:

     (a) personal accounts, and (b) cash book are maintained.

  2. Although these accounts are kept on the basis of double entry system, postings from cash book are made only to personal accounts
- **Quasi single entry**
  1. In this: (a) personal accounts, (b) cash book, and (c) some subsidiary books are maintained.
  2. The main subsidiary books kept under this system are Sales book, Purchases book and Bills book.
  3. Regarding expenses only scattered information is available
  4. Generally adopted method

FEATURES OF SINGLE-ENTRY SYSTEM

★ It is an inaccurate, unscientific and unsystematic method of recording business transactions.

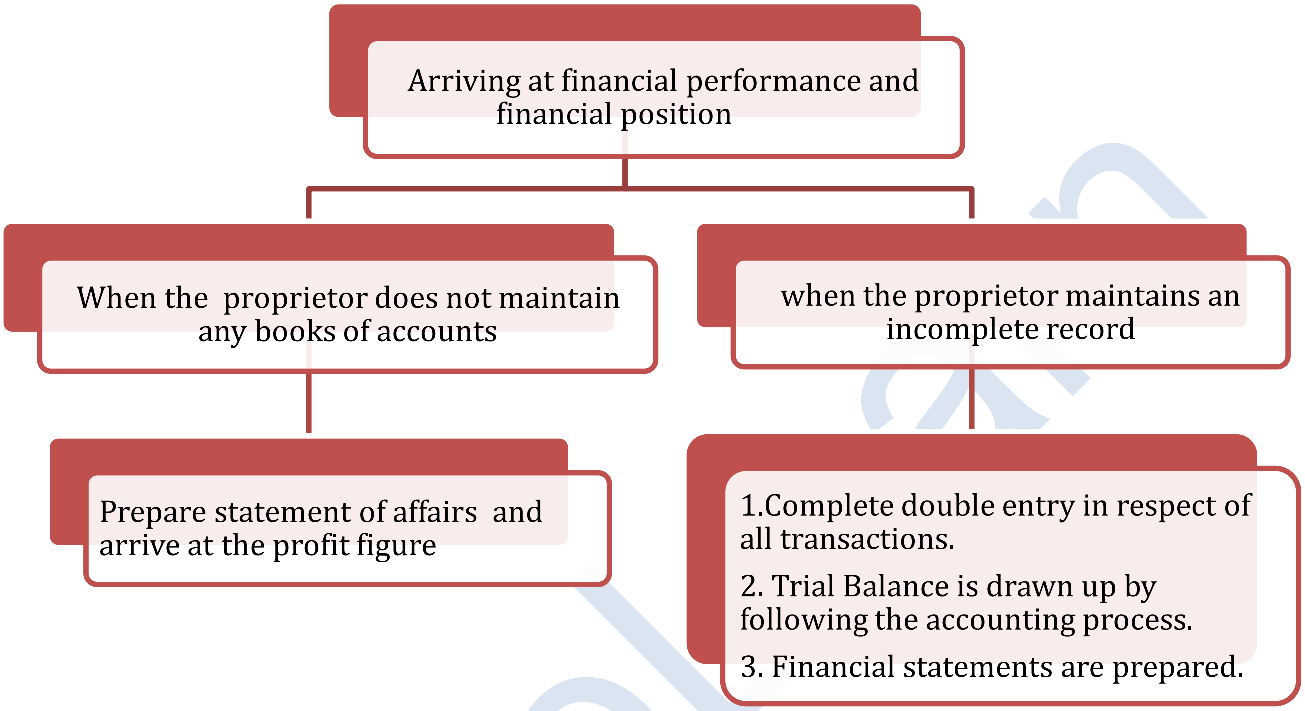
★ There is generally no record of real and personal accounts and, in most of the cases; a record is kept for cash transactions and personal accounts.

★ Cash book mixes up business and personal transactions of the owners.

★ There is no uniformity in maintaining the records and the system may differ from firm to firm depending on the requirements and convenience of each firm.

★ Profit under this system is only an estimate based on available information and therefore true and correct profits cannot be determined. The same is the case with the financial position in the absence of a proper balance sheet.

FINANCIAL PERFORMANCE AND FINANCIAL POSITION



ASCERTAINMENT OF PROFIT THROUGH STATEMENT OF AFFAIRS

If detailed information regarding revenue and expenses is not known, it becomes difficult to prepare profit and loss account. Instead by collecting information about assets and liabilities, it is easier to prepare balance sheet at two different points of time. So, while preparing accounts from incomplete records, if sufficient information is not available, it is better to follow the **method of capital comparison** to arrive at the profit figure.

This method is also known as **Net Worth method** or **Statement of Affairs Method**.

Closing Capital – Opening Capital = Profit

The above formula can also be expanded as below:

Capital at the end (a)	xxx
Add: Drawings	xxx
Less: Fresh capital introduced	xxx
Capital at the beginning (b)	xxx
Profit (a – b)	xxx

Opening and closing capital can be determined by preparing statement of affairs at the two respective points of time.

Statement of affairs is prepared in the following format. The opening and the closing balance is a balancing figure.

Statement of affairs as on…………

Liabilities	Amount 20xx	Amount 20x1	Assets	Amount 20xx	Amoun t 20x1
Capital (balancing figure)	xxx	xxx	Building	xxx	xxx
Loans, Bank overdraft	xxx	xxx	Machinery	xxx	xxx
Sundry creditors	xxx	xxx	Furniture	xxx	xxx
Bills payable	xxx	xxx	Inventory	xxx	xxx
Outstanding expenses	xxx	xxx	Sundry debtors	xxx	xxx
			Cash and bank	xxx	xxx
			Prepaid expenses	xxx	xxx
	xxx	xxx		xxx	xx

Sources of assets and liabilities: -

Item	Source of information
Cash and bank	Cash book and bank passbook
Debtors and Creditors	Personal ledger
Inventory	actual counting and valuation
Fixed assets	The proprietor would disclose the original cost and date of purchase. Reasonable amount of depreciation can be deducted from the same.
Loans, Bank overdraft	Corresponding bank documents
Prepaid and outstanding expenses	Prepaid expense – corresponding documentary proof Outstanding expense – Proprietor must provide this information.

DIFFERENCE BETWEEN STATEMENT OF AFFAIRS AND BALANCE SHEET

Basis	**Statement of affairs**	**Balance sheet**
Reliability	It is prepared based on transactions partly recorded based on double entry book keeping and partly based on single entry. Most of the assets are recorded based on estimates, assumptions, information gathered from memory rather than records.	It is based on transactions recorded strictly based on double entry book keeping; Each item in the balance sheet can be verified from the relevant subsidiary books and ledger. Hence the balance sheet is not only reliable, but also dependable.
Capital	In this statement, capital is merely a balancing figure being excess of assets over capital. Hence assets need not be equal to liabilities.	Capital is derived from the capital account in the ledger and therefore the total of assets side will always be equal to the total of liabilities side.
Omission	Since this statement is prepared based on incomplete records, it is very difficult, to locate the assets and liabilities, if they are omitted from the books.	There is no possibility of omission of any item of asset and liability since all items are properly recorded. Moreover, it is easy to locate the missing items since the balance sheet will not agree.
Basis of Valuation	The valuation of assets is generally done in an arbitrary manner; therefore, no method of valuation is disclosed.	The valuation of assets is done on scientific basis, that is original cost in the case of new assets and depreciated amount based on cost minus depreciation to date for used assets. Any change in the

		method of valuation is properly disclosed.
Objects	The object of preparing this statement in the calculation of capital figures in the beginning and at the end of the accounting period respectively.	The object of preparing the balance sheet is to ascertain the financial position on a particular date.

ASCERTAINMENT OF PROFIT BY COMPLETING BOOKS OF ACCOUNTS

★ Where the accounts of a business are incomplete, it is advisable to convert them first to the double entry system and then to draw up the Profit and Loss Account and the Balance Sheet.

★ As books of accounts of different firms being incomplete in varying degrees, it is not possible to suggest a formula which could uniformly be applied for preparing final accounts there from.

★ However, the following general rule can be followed:

1. It is essential first to start the ledger accounts with the opening balances of assets, liabilities and the capital.
2. Afterwards, each book of original entry should be separately dealt with, so as to complete the double entry by posting into the ledger such entries as have not been posted. For example, if only personal accounts have been posted from the Cash Book, debits and credits pertaining to nominal accounts and real accounts that are not posted, should be posted into the ledger.
3. Afterwards, the other subsidiary books, i.e., Purchases Day Book, Sales Day Book, Return Book and Bills Receivable and Payable, etc. should be totaled up and their totals posted into the ledger to the debit or credit of the appropriate nominal or real accounts, the personal aspect of the transactions having been posted already.
4. Once all the ledgers have been updated, prepare a trial balance to confirm the arithmetical accuracy.
5. From the trial balance, prepare the financial statements.

When an Accountant is engaged in posting the unposted items from the Cash Book and other subsidiary books, he may be confronted with a number of problems. The manner in which some of them may be dealt with is described below:

Problems encountered by Accountants	**Solutions**

1. In the Cash Book, there might be entered several receipts and payments which have no connection with the business but which belong to the proprietor, e.g., interest collected on his private investment, legacies received by him, purchase of car as gift for his son, expenses of his pleasure trip etc.	All the personal receipts should be credited to his capital account. And his personal expenses should be debited to his capital account.
2. Amounts belonging to the business after collection may have been directly utilised for acquiring business assets or for meeting certain expenses instead of being deposited into the Cash Book.	The appropriate asset or expense account should be debited and the source which had provided funds credited
3. The proprietor may have met some of the business expenses from his private resources.	The appropriate asset or expense account should be debited, and the capital account should be credited
4. Any excess or shortage in cash book for unidentified reasons	Should be adjusted with Proprietor's capital account.
5. Where the benefit of an item of an expense is received both by the proprietor and business	It should be allocated between them on some equitable basis e.g. rent of premises when the proprietor lives in the same premises, should be allocated based on the area occupied by him for residence.
6. Analysis of cash and bank receipts and payments in detail.	Should be done in extensive manner. Prepare Cash and Bank Summary (if not available in proper form with both sides tallied). The cash and bank balance at the end should be reconciled with the cash and bank books. Having done so, the various items detailed on the Summary Statements, should be posted into the ledger. The balancing figure in the summary can be opening balance of cash, cash sales or cash purchases. This is based on other available information.
7. Analysis of sales and purchases ledger.	This should be done by considering all the information regarding credit sales, purchases, discount allowed/received,

	bad debts, return inwards/outwards, bills received/ dishonored, etc.
8. Analysis of nominal accounts	This should be done by considering the outstanding and prepaid expenses during the period.

Analysis of Sales Ledger

It would disclose information pertaining to the opening balance of the debtors, the goods sold to them on credit during the year, bills receivable dishonored, if any; cash received from them in the accounting period, discount, rebate or any other concession allowed to them, receipts of bills receivable, returns inwards, bad debts written off and transfers which can be shown in the following format.

OP Customer Balance	Sales	Bills Dishonored	Total Debits	Cash Recd.	Discounts Allowed	Bills Recd.	Bad debts	Sales Returns	Total credit	Balance (CL)

Journal entries must be made by debiting or crediting the impersonal accounts concerned with contra credit or debit given to total debtors account.

From the aforementioned, it will be possible to build up information about sales and other accounts which can then be posted in totals, if so desired. It would also be possible to prepare Total Debtors.

Analysis of Purchases Ledger

A Purchases Ledger is not as commonly in existence as the Debtors Ledger for it being convenient to make entries in respect of outstanding liabilities at the time, they are paid rather than when they are incurred.

The information is available in respect of opening balance of the creditors, goods purchased on credit, bills payable dishonored; cash paid to the creditors during the year, discount and other concessions obtained, returns outwards and transfers. It is made in the similar format as the sales ledger.

Journal entries must be made by debiting or crediting the respective impersonal accounts. Contra credit or debit being given to total creditor's account.

If a proper record of return to creditors, discount allowed by them etc., has not been kept, it will not be possible to write up the Total Creditors A/c.

In such a case, net credit purchase will be ascertained as follows:

Cash paid to Creditors including on account of bills payable during the period	xxx
Closing balance of Creditors and Bills Payable	xxx
Total	xxx
Less: Opening balance of Creditors and Bills Payable	xxx
Net credit purchase during the period	xxx

Alternatively

Cash paid to Creditors during the period	xxx
Add: Bills Payable issued to them	xxx
Total	xxx
Closing balance of Creditor	xxx
Less: Opening balance of creditors	xxx
Credit Purchases during the period	xxx

Analysis of Nominal accounts

It is quite likely that the total expenditure shown by balance of nominal account may contain items of expenditure which do not relate to the year for which accounts are being prepared and, also, there may exist certain items of expenditure incurred but not paid, which have not been included therein. On that account, each and every account should be adjusted in the following manner:

Particulars (1)	Cash payment (2)	Bank payment (3)	Outstanding payment (4)	Total paid/payable (5) = 2 +3 + 4	Pre-paid amount (6)	Expenses for the period (7) = 5 – 6
Office rent						
Salaries						

Only the amount entered as "expenses for the period" should be posted to the respective nominal accounts.
A similar adjustment of nominal accounts in respect of revenue receipt should be made.

Scan the business transactions carefully to identify the nature of payment/ receipt and classify them as drawings / fresh investments.

The following are some examples of drawings and fresh investment made by the proprietor/partner.

Drawings	**Fresh investment**
Rent of premises commonly used for residential as well as business purposes	Money collected and put in the business on maturity of Life Insurance Policy of the proprietors
Common electricity and telephone bills	Interest and dividend of personal investment of the proprietors collected and put in the business.
Life insurance premiums of proprietor/partners paid from business cash.	Income from non-business property collected and put in the business
Household expenses met from business cash	Business expenses met by the proprietor from his personal bank account.
Private loan paid to friends and relatives out of business cash	Payment made to any creditor out of proprietor's personal account.
Personal gifts made to any friends and relatives out of business cash	
Goods or services taken from the business for personal consumption	
Cash withdrawals to meet family expenses	

Illustrations

Illustration - 1

Assets and Liabilities of Mr. X as on 31-12-2015 and 31-12-2016are as follows:

Particulars	**31-12-2015 (Rs.)**	**31-12-2016 (Rs.)**
Assets		
Building	1,00,000	?
Furniture	50,000	?
Inventory	1,20,000	2,70,000
Sundry debtors	40,000	90,000
Cash at bank	70,000	85,000
Cash in hand	1,200	3,200
Liabilities		
Loans	1,00,000	80,000
Sundry creditors	40,000	70,000

- Decided to depreciate building by 2.5% and furniture by 10%.
- One Life Insurance Policy of the Proprietor was matured during the period and the amount Rs. 40,000 is retained in the business.
- Proprietor took @ Rs. 2,000 p.m. for meeting family expenses.

Prepare Statement of Affairs.

Illustration - 2

The Income Tax Officer, on assessing the income of Shri Moti for the financial year 1 and year 2 feels that Shri Moti has not disclosed the full income. He gives you the following particulars of assets and liabilities of Shri Moti as on 1st Jan Yr. 1 and 1st Jan Yr. 3.

				Amount (Rs.)
1st Jan Yr. 1	Assets	:	Cash in hand	25,500
			Inventory	56,000
			Sundry debtors	41,500
			Land and Building	1,90,000
			Wife's Jewellery	75,000
	Liabilities	:	Owing to Moti's Brother	40,000
			Sundry creditors	35,000
1st Jan Yr. 2	Assets	:	Cash in hand	16,000
			Inventory	91,500
			Sundry debtors	52,500
			Land and Building	1,90,000
			Motor Car	1,25,000

			Wife's Jewellery	1,25,000
			Loan to Moti's Brother	20,000
	Liabilities	:	Sundry creditors	55,000

During the two years the domestic expenditure was Rs. 4,000 p.m. The declared income of the financial years were Rs. 1,05,000 for Yr. 1 and Rs. 1,23,000 for Yr. 2 respectively. State whether the Income-tax Officer's contention is correct. Explain by giving your workings.

Illustration – 3

A and B are in Partnership having Profit sharing ratio 2:1. The following information is available about their assets and liabilities:

Particulars	**31-3-2016**	**31-3-2017**
	Amount (Rs.)	Amount (Rs.)
Furniture	1,20,000	?
Advances	70,000	50,000
Creditors	32,000	30,000
Debtors	40,000	45,000
Inventory	60,000	74,750
Loan	80,000	—
Cash at Bank	50,000	1,40,000

- The partners are entitled to salary @ Rs. 2,000 p.m. They contributed <u>proportionate capital.</u>
- Interest is paid @ 6% on capital and charged @ 10% on drawings.

Drawings of A and B

Particulars	**A**	**B**
	Amount (Rs.)	**Amount (Rs.)**
April 30	2,000	—
May 31	—	2,000
June 30	4,000	—
Sept. 30	—	6,000
Dec. 31	2,000	—
Feb. 28	—	8,000

- On 30th June, they took C as 1/3rd partner who contributed Rs. 75,000.
- C is entitled to share of <u>9 months' profit</u>.
- The new profit ratio becomes 1:1:1.
- A withdrew his proportionate share.
- Depreciate furniture @ 10% p.a., new purchases Rs. 10,000 may be depreciated for 1/4th of a year
- Current account as on 31-3-2016: A Rs. 5,000 (Cr.), B Rs. 2,000 (Dr)

- Prepare Statement of Profit, Current Accounts of partners and Statement of Affairs as on 31-3-2017.

Illustration - 4

The following information relates to the business of Mr. Shiv Kumar, who requests you to prepare a Trading and Profit & Loss Account for the year ended 31st March, Year2 and a Balance Sheet as on that date:

(a)

Particulars	Balance as on 31st March, Year1 (Rs.)	Balance as on 31st March, Year2 (Rs.)
Building	3,20,000	3,60,000
Furniture	60,000	68,000
Motorcar	80,000	80,000
Inventory	?	40,000
Bills payable	28,000	16,000
Cash and bank balances	1,80,000	1,04,000
Sundry debtors	1,60,000	?
Bills receivable	32,000	28,000
Sundry creditors	1,20,000	?

(b) Cash transactions during the year included the following besides certain other items:

Particulars	Amount (Rs.)	Particulars	Amount (Rs.)
Sale of old papers and miscellaneous income	20,000	Cash purchases	48,000
Miscellaneous Trade expenses (including salaries etc.)	80,000	Payment to creditors	1,84,000
Collection from debtors	2,00,000	Cash sales	80,000

(c) **Other information:**

- Bills receivable drawn during the year amount to Rs.20,000 and Bills payable accepted Rs.16,000.
- Some items of old furniture, whose written down value on 31st March, Year1 was Rs.20,000 was sold on 30th September, Year1 for Rs.8,000. Depreciation is to be provided on Building and Furniture @ 10% p.a. and on Motorcar @ 20% p.a. Depreciation on sale of furniture to be provided for 6 months and for additions to Building for whole year.
- Of the Debtors, a sum of Rs.8,000 should be written off as Bad Debt and a reserve for doubtful debts is to be provided @ 2%.

- Mr. Shivkumar has been maintaining a steady gross profit rate of 30% on turnover.
- Outstanding salary on 31st March, Year1 was Rs.8,000 and on 31st March, Year2 was Rs.10,000. On 31st March, Year1, Profit and Loss Account had a credit balance of Rs.40,000.
- 20% of total sales and total purchases are to be treated as for cash.
- Additions in Furniture Account took place in the beginning of the year and there was no opening provision for doubtful debts.

Illustration - 5

From the following data, you are required to prepare a Trading and Profit and Loss Account for the year ended 31st March, Year 2 and a Balance Sheet as at that date. All workings should form part of your answer.

Particulars	As on 01-04-x1 (Rs.)	As on 31-03-x2 (Rs.)
Creditors	15,770	12,400
Sundry expenses outstanding	600	330
Sundry Assets	11,610	12,040
Inventory in trade	8,040	11,120
Cash in hand and at bank	6,960	8,080
Trade debtors	?	17,870
Details relating to transactions in the year:		
Cash and discount credited to debtors		64,000
Sales return		1,450
Bad debts		420
Sales (cash and credit)		71,810
Discount allowed by trade creditors		700
Purchase returns		400
Additional capital-paid into Bank		8,500
Realisations from debtors-paid into Bank		62,500
Cash purchases		1,030
Cash expenses		9,570
Paid by cheque for machinery purchased		430
Household expenses drawn from Bank		3,180
Cash paid into Bank		5,000
Cash drawn from Bank		9,240
Cash in hand on 31-3-x2		1,200
Cheques issued to trade creditors		60,270

Illustration - 6

Adamjee keeps his books on single entry basis. The analysis of the cash book for the year ended on 31st December, 20X1 is given below:

Receipts	Rs.	Payments	Rs.
Bank Balance as on 1st January, 20X1	2,800	Payment to Sundry Creditors	35,000
Received from Sundry Debtors	48,000	Salaries	6,500
Cash Sales	11,000	General Expenses	2,500
Capital brought during the year	6,000	Rent and Taxes	1,500
Interest on Investments	200	Drawings	3,600
		Cash Purchases	12,000
		Balance at Bank on 31st Dec, 20X1	6,400
		Cash in hand on 31st Dec., 20X1	500
	68,000		**68,000**

Particulars of other assets and liabilities are as follows:

	1st January 20X1	31st December 20X1
Sundry Debtors	14,500	17,600
Sundry Creditors	5,800	7,900
Machinery	7,500	7,500
Furniture	1,200	1,200
Inventory	3,900	5,700
Investments	5,000	5,000

Prepare final accounts for the year ending 31st December, 20X1 after providing depreciation at 10 percent on machinery and furniture and Rs. 800 against doubtful debts

Illustration - 7

Mr. Anup runs a wholesale business where in all purchases and sales are made on credit. He furnishes the following closing balances:

	1-1-20X1	31-12-20X1
Sundry Debtors	70,000	92,000
Bills Receivable	15,000	6,000
Bills Payable	12,000	14,000
Sundry Creditors	40,000	56,000
Inventory	1,10,000	1,90,000
Bank	90,000	87,000

Cash	5,200	5,300

Summary of cash transactions during the year 20X1:

i. Deposited to bank after payment of shop expenses
   - @ Rs. 600 p.m., wages
   - @ Rs. 9,200 p.m. and personal expenses
   - @ Rs. 1,400 p.m. Rs. 7,62,750.

i. Withdrawals Rs. 1,21,000.
ii. Cash payment to suppliers Rs. 77,200 for supplies and Rs. 25,000 for furniture.
iii. Cheques collected from customers but dishonored Rs. 5,700.
iv. Bills accepted by customers Rs. 40,000.
v. Bills endorsed Rs. 10,000.
vi. Bills discounted Rs. 20,000, discount Rs. 750 Bills matured and duly collected Rs. 16,000.
vii. Bills accepted Rs. 24,000.
viii. Paid suppliers by cheque Rs. 3,20,000.
ix. Received Rs. 20,000 on maturity of one LIC policy of the proprietor by cheque.
x. received Rs. 14,000 by cheque for the premises owned by proprietor.
xi. building was purchased on 30-11-20X1 for opening a branch for Rs. 3,50,000 and some expenses were incurred on this building, details of which are not maintained.
xii. and telephone bills paid by cash Rs. 18,700, due Rs. 2,200.

Other transactions:

i. Claim against the firm for damage Rs. 1,55,000 is under legal dispute. Legal expenses Rs. 17,000. The firm anticipates defeat in the suit.
ii. Goods returned to suppliers Rs. 4,200.
iii. Goods returned by customers Rs. 1,200.
iv. Discount offered by suppliers Rs. 2,700.
v. Discount offered to the customers Rs. 2,400.
vi. The business is carried on at the rented premises for an annual rent of Rs. 20,000 which is outstanding at the year end.

Prepare Trading and Profit & Loss Account of Mr. Anup for the year ended 31-12-20X1 and Balance Sheet as on that date.

Illustration - 8

Ms. Rashmi furnishes you with the following information relating to her business:

a. Assets and liabilities as on

Particulars	1.1. Year1	31.12. Year1
	Amount (Rs.)	Amount (Rs.)
Furniture (w.d.v)	12,000	12,700
Inventory at cost	16,000	14,000
Sundry Debtors	32,000	?
Sundry Creditors	22,000	30,000
Prepaid expenses	1,200	1,400

Unpaid expenses	4,000	3,600
Cash in hand and at bank	2,400	1,250

b. Receipts and payments during 2016:

- Collections from debtors, after allowing discount of Rs. 3,000 amounted to Rs. 1,17,000.
- Collections on discounting of bills of exchange, after deduction of discount of Rs. 250 by the bank, totaled to Rs. 12,250.
- Creditors of Rs. 80,000 were paid Rs. 78,400 in full settlement of their dues.
- Payment for freight inwards Rs. 6,000.
- Amount withdrawn for personal use Rs. 14,000.
- Payment for office furniture Rs. 2,000.
- Investment carrying annual interest of 4% were purchased at Rs. 192 (face value Rs. 200) on 1st July,2016 and payment made there for.
- Expenses including salaries paid Rs. 29,000.
- Miscellaneous receipts Rs. 1,000

c. Bills of exchange drawn on and accepted by customers during the year amounted to Rs. 20,000. Of these, bills of exchange of Rs. 4,000 were endorsed in favour of creditors. An endorsed bill of exchange of Rs. 800 was dishonored.

d. Goods costing Rs. 1,800 were used as advertising materials.

e. Goods are invariably sold to show a gross profit of 33-1/3% on sales.

f. Difference in cash book, if any, is to be treated as further drawing or introduction of capital by Ms. Rashmi.

g. Provide at 2.5% for doubtful debts on closing debtors.

Prepare trading and profit and loss account for the year ended 31st December,2016 and the balance sheet as on that date.

ACCOUNTING STANDARD

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.

Accounting 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 Companies Act had earlier notified 28 accounting standards and mandated the corporate entities to comply with the provisions stated therein. However, in 2016 the MCA has withdrawn AS 6. Hence, effectively there are now only 27 notified Accounting Standards as per the Companies (Accounting Standards) Rules, 2006 (as amended in 2016).

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. So commercial activity is the basis for application of accounting standards.

The Accounting Standards are intended to apply only to items, which are material.

Accounting standards are not applicable to all forms of organisations, they can be categorized into companies and other than company entities.

Section 129(1) of the Companies Act 2013 states "The financial statements shall give a true and fair view of the state of affairs of the company or companies, comply with the accounting standards notified under section 133 and shall be in the form or forms as may be provided for different class or classes of companies in Schedule III:

Provided that the **items contained in such financial statements shall be in accordance with the accounting standards**"

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 Institute of Chartered Accountants of India, constituted under section 3 of the Chartered Accountants Act, 1949, in consultation with and after examination of the recommendations made by the National Financial Reporting Authority."

Criteria for Classification of Entities and Applicability of Accounting Standards

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.

Types of Companies

- Small and Medium-sized Companies (SMCs)
- Other than SMCs (Non SMCs)

Small and Medium-sized Company 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 Rs.250 crores in the immediately preceding accounting year

(iv) which does not have borrowings (including public deposits) in excess of Rs.50 crores at any time during the immediately preceding accounting year and

(v) which is not a holding or subsidiary company of a company which is not a SMC

Category	Condition
Debt / Equity Listed	Should not be listed or in process of listing in India or outside India
Type of company	Should not be a bank, financial Inst or Insurance Co.
Turnover (PY) (Excluding Other Income)	Should not exceed (≤) 250 Crores
Borrowing (Inc. Public Deposits)	Should not exceed (≤) 50 crores
Holding/Subsidiary	Should not be a holding/Subsidiary of a non-SMC

All accounting standards are applicable to Non-SMC. But applicability of all AS is not mandatory for SMCs.

Accounting Standard	Applicable (Yes / No) to SMC

AS 1 Disclosure of Accounting Policies	Yes
AS 2 Valuation of Inventories	Yes
AS 3 Cash Flow Statements	No
AS 4 Contingencies and Events Occurring After the Balance Sheet Date	Yes
AS 5 Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies	Yes
AS 7 Construction Contracts	Yes
AS 9 Revenue Recognition	Yes
AS 10 Property, Plant and Equipment	Yes
AS 11 The Effects of Changes in Foreign Exchange Rates	Yes
AS 12 Accounting for Government Grants	Yes
AS 13 Accounting for Investments	Yes
AS 14 Accounting for Amalgamations	Yes
AS 15 Employee Benefits	Partial
AS 16 Borrowing Costs	
AS 17 Segment Reporting	No
AS 18 Related Party Disclosures	
AS 19 Leases	Partial
AS 20 Earnings Per Share	Partial
AS 21 Consolidated Financial Statements	No
AS 22 Accounting for Taxes on Income	
AS 23 Accounting for Investments in Associates in Consolidated Financial Statements	No
AS 24 Discontinuing Operations	
AS 25 Interim Financial Reporting	Partial
AS 26 Intangible Assets	
AS 27 Financial Reporting of Interests in Joint Ventures	No
AS 28 Impairment of Assets	Partial
AS 29 Provisions, Contingent Liabilities and Contingent Assets	Partial

SMC - Guiding Principles

- Disclosure

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

- If SMC in previous year, but not in current year, previous year's figures are not required to be revised.

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

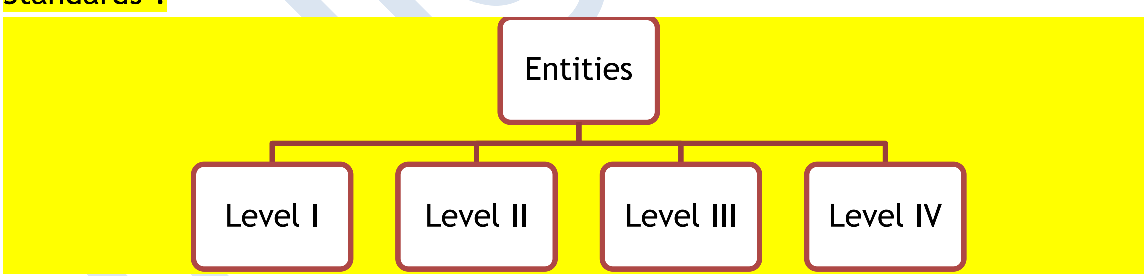
- If an SMC desires to disclose the information not required to be disclosed pursuant to the exemptions or relaxations available to the SMCs, it should disclose that information in compliance with the relevant accounting standard.

- 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.

- 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.

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'.



Level	I	II	III	IV
Type	Large	Medium	Small	Micro

Listed	Listed / In Process			Residual Category
Business	Banks, FI & Insurance			
Turnover (Crores)	> 250	> 50	> 10	
Borrowings (Crores)	> 50	> 10	> 2	
Holding/ Subsidiary	Level I	Level II	Level III	

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)

(2) Where Level II or Level III or Level IV entity previously qualified for exemption / relaxation but not eligible anymore in current accounting need not revise previous year figures. It should only disclose that such relaxation is not more applicable and previous year figures have not been changed as per AS.

(3) Where an entity has been covered in Level I and subsequently gets covered in Level II or Level III or Level IV, the entity will qualify for exemption/relaxation available only after two consecutive years of that status. Similar for any change in status.

(4) If an entity covered in any Level opts not to avail few of the exemptions or relaxations the AS, it shall disclose the Standard(s) in respect of which it has availed the exemption or relaxation.

(5)

All accounting standards are applicable for Level I Entities
AS 1,2,4,5,7,8,9, 12, 16 are applicable for Level II, III, IV entities

AS	II	III	IV
3 – Cash Flow Statement	NA	NA	NA
10 – Property, Plant and Equipment	Applicable	Disclosure Exemptions	
11 - The Effects of Changes in Foreign Exchange Rates	Applicable	Disclosure Exemptions	
13 - Accounting for Investments	Applicable	Applicable	Disclosure Exemptions
14 - Accounting for Amalgamations	Applicable	Applicable	NA
15 - Employee Benefits	Applicable with Exemptions		
17 - Segment Reporting	NA	NA	NA
18 - Related Party Disclosures	Applicable	NA	NA
19 - Leases	Disclosure Exemptions		
20 – Earnings Per Share	NA	NA	NA
21 – Consolidated Financial Statement	NA	NA	NA
22 – Accounting for Taxes on Income	Applicable	Applicable	Only Current Tax
23 - Accounting for Investments in Associates in Consolidated Financial Statements	NA	NA	NA
24 - Discontinuing Operations	NA	NA	NA
25 - Interim Financial Reporting	NA	NA	NA
26 - Intangible Assets	Applicable	Applicable	Disclosure Exemptions
27 - Financial Reporting of Interests in Joint Ventures	NA	NA	NA
28 - Impairment of Assets	Exemptions		NA
29 - Provisions, Contingent Liabilities and Contingent Assets	Disclosure Exemptions		

AS -1

1.1: Objective of AS 1: This statement deals with the disclosure of significant accounting policies followed in preparing & presenting financial statements. The purpose of this statement is to promote better understanding of financial statements by establishing through an accounting standard the disclosure of significant accounting policies and the manner in which accounting policies are disclosed in the financial statements. Such disclosure would also facilitate a more meaningful comparison between financial statements of different enterprises.

1.2: Fundamentals Accounting Assumptions: There are certain accounting concepts, which are very fundamental to the process of preparation of Financial Statements. Since, these concepts are very basic and widely accepted; it is assumed that Financial Statements are prepared by adhering to these concepts.

AS-1 identifies such fundamental Accounting Assumptions

a) Going concern
b) Accrual
c) Consistency

These three concepts are so fundamental that their acceptance and use are assumed in the preparation of financial statements. If above fundamental accounting assumptions are not followed, the fact should be disclosed clearly in the financial statements together with reasons.

Accounting assumptions are explained in the paragraphs that follow:

a) Going Concern: The enterprise is normally viewed as a going concern. It is assumed that enterprise has neither the intention nor the necessity of liquidation or of curtailing materially the scale of its operations. Joint venture is an exception. Going concern concept is not followed in the context of Joint Venture. If an enterprise is not going concern, valuation of its assets and liabilities on historical cost becomes irrelevant and as a consequence it's profit or loss may not give reliable information.
b) **Accrual:** Revenue and costs are recognized and recorded in the books of accounts as they are earned or incurred. (And not as money is received of paid). Thus, all revenues and costs for the period are to be recorded even if cash is not actually received or paid. This concept is the core of mercantile system of accounting.
c) Consistency: The investors require such information that enables them to compare the performance of various companies, particularly, the companies in

the same industry. Other users like banker, creditor, Govt. value comparability of the statements. For ensuring the quality of comparability, it is necessary that there should be consistency in using accounting policy.

Consistency has its virtues but situations may develop needing a change of accounting measurement adopted earlier, so as to reflect result. In such a situation, a departure from this concept is permissible only by making a full disclosure about the change and the monetary effect of the change on the financial statements.

1.3: Nature of Accounting Policies:

1. The accounting policies refer to the specific accounting principles and the method of applying those principles adopted by the enterprise in the preparation and presentation of financial statements.
2. There is no single list of accounting policies which are applicable to all circumstances. The differing circumstances in which enterprises in which enterprises operate in a situation of diverse and complex economic activity make alternative accounting principles and method of applying those principles acceptable. The choice of the appropriate accounting principles and the methods of applying those principles in the specific circumstances of each enterprise calls for considerable judgment by the management of the enterprise.

An Illustrative list of Accounting Policies is given below:

i. Accounting conventions followed.
ii. Basic of accounting – Historical or Current cost.
iii. Valuation of inventory
iv. Valuation of Investments.
v. Valuation of fixed assets including revaluation.
vi. Policies relating to depreciation of fixed assets.
vii. Translation of foreign currency transactions or items.
viii. Treatment of Government grants.
ix. Treatment of goodwill.
x. Recognition of a liability for retirement benefits.
xi. Recognition of profit on long-term contracts.
xii. Absorption of costs incurred on research and development.
xiii. Treatment of preliminary or capital issue expenses.
xiv. Treatment of Lease rental income or lease rental payment.
xv. Treatment of expenditure during construction.
xvi. Treatment of contingent liabilities.
xvii.

1.4: Selection of Appropriate Accounting Policies: Selection of accounting policies is guided by "TRUE AND FAIR" concept. In other words accounting policies adopted by the organization should ensure that Financial Statements do give true view of financial position and performance. AS – 1 identifies following “there major considerations” for selecting accounting policies.

a) **Prudence:** Prudence is inclusion of a degree of caution while making estimates required under the conditions of uncertainty. The prudence concept implies that profits are not to be accounted on estimated basis. Profits are recognized only when they are realized in cash or a third party has legally become liable to pay the amount. However all anticipated losses are to be accounted for. ***Example: Inventory is value at cost or NRV whichever is lower.***

b) **Substance Over Form:** If financial statements are to represent faithfully, the transactions and events, it is essential that they are accounted for and presented in accordance with their substance and economic reality and not merely their legal form.

   E.g. In a finance lease, though lessor continuous to be legal owner of the asset, he is transferring the risk and reward incidental (attached) to the ownership of the asset. Lessee is using asset for generating revenue, and hence asset is recognized in his books. Thus, Balance sheet of lessee reflects, Assets taken on lease and corresponding liability towards the lessor on account of lease payments. Depreciation on such asset is debited to lessee’s P & L Account.

c) **Materiality:** AS-1 states that financial statements should disclose all material items.

Material items are those, the knowledge of which might influence the decisions of the user of the financial statements. Materiality is a relative term. It is not possible to lay down precisely either in term of specific accounts or in terms of amounts of the items, which could be considered as material in another. Therefore, the decision to judge the materiality of the item shall depend upon the judgment of the individual.

1.5: Disclosure requirements: All significant accounting policies adopted in the preparation and presentation of financial statements should be disclosed.

1. 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.
2. 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.
3. 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.

Share Capital

The information relating to share capital can be disclosed in the balance sheet or statement of changes in equity as part of balance sheet or in notes. A description of nature and purpose of each reserve within equity should be disclosed.

For each class of share capital (different classes of preference shares to be treated separately), following disclosures are required to be made:

a) Number of shares authorized

b) Number of shares issued and fully paid and issued but not fully paid

c) Par value per share or shares that have no par value

d) a reconciliation of the number of shares outstanding at the beginning and at the end of the reporting period;

e) the rights, preferences and restrictions attaching to each class of shares;

f) shares in the company held by itself or its subsidiaries or associates;

g) Shares reserved for issue under options and contracts for sale of shares

Illustrations

Q1: Which of the following are not parts of the term financial statements?

1. Profit and Loss Account
2. Balance Sheet
3. Cash Flow Statement
4. Notes to Financial Statements
5. **MD&A**
6. **Directors Report**
7. **Auditors' Report**

Q2: Choose the correct answer / answers for the statement made below:

As per AS 1, every entity whether a corporate / individual / government / non-governmental organization or any other body of person should follow the 3 fundamental accounting assumptions without exception.

1. Yes, these are common for all entities and no one should violate them
2. Only Companies and other Bodies of persons are expected to follow these assumptions. Sole proprietors / partnerships need not follow these assumptions.
3. **All of form of organizations / Bodies of persons / individuals are expected to disclose if they are following these assumptions.**
4. Other than accrual, which need not be followed by government / individuals other two assumptions must always be followed by all others

Feedback: AS 1 is a disclosure based standard. It prescribes the disclosures that an entity should make with respect to fundamental accounting assumptions and accounting policies. It does not differentiate between constitutions of business. Specific rules for different constitution of business / organizations are set by respective statutory bodies if any and not by AS1. According to AS 1, the 3 fundamental accounting assumptions are assumed in all financial statements unless a specific disclosure is made that they have not been follow. Eg Going concern: If an entity is on the verge of bankruptcy, it is expected to disclose such a matter in its financial statements.

Q3: What are the 3 fundamental accounting assumptions? Choose the right option

a. Going concern, Materiality, Prudence
b. Prudence, Substance over form, Materiality
c. **Consistency, Accrual, Going Concern**
d. Accrual, Prudence, Consistency

Feedback: Consistency, Accrual & Going Concern are three fundamental accounting assumptions

Illustration 1

In the books of M/s Prashant Ltd., closing inventory as on 31.03.2015 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 2014 -15. On the basis of weighted average method, closing inventory as on 31.03.2015 amounts to Rs. 1,47,000. Realisable value of the inventory as on 31.03.2015 amounts to Rs. 1,95,000.

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

Illustration 2

ABC Ltd. was making provision for non-moving inventories based on issues for the last 12 months up to 31.3.2016. The company wants to provide during the year ending 31.3.2017 based on technical evaluation:

- Total value of inventory Rs. 100 lakhs
- Provision required based on 12 months issue Rs. 3.5 lakhs
- Provision required based on technical evaluation Rs. 2.5 lakhs

Does this amount to change in Accounting Policy? Can the company change the method of provision?

Illustration 3

Jagannath Ltd. had made a right issue in 1996. In the offer document to its members, it had projected a surplus of Rs. 40 crores during the accounting year to end on 31st March 1998. The draft results for the year prepared on the hitherto followed accounting policies and presented for perusal of the Board of Directors showed a deficit of Rs. 10 crores.

The Board, in consultation with the Managing Director, decided on the following:

Value year-end inventory at works cost (Rs. 50 crores) instead of the hitherto method of valuation of inventory at Prime Cost (Rs. 30 crores).

(ii) Provide depreciation for the year on straight line basis or account of substantial additions in gross block during the year, instead of on the Reducing Balance Method, which had been hitherto adopted. As a consequence, the charge for depreciation at Rs. 27 crores is lower than the amount of Rs. 45 crores —which would have been provided had the old method been followed—by Rs. 18 crores.

(iii) Not to provide for "after—sales expenses" during the warranty period. Till the last year, provision at 2% on sales used to be made under the concept of "matching of cost against revenue" and actual expenses used to be charged against the provision. The Board now decided to account for expenses as and when actually incurred. Sales during the year total to Rs. 600 crores.

As chief accountant of the company, you are asked by the Managing Director to draft the Notes on Accounts for inclusion in the annual report for 1997-98.

AS-2

Objective:

The objective of this chapter is to prescribe the accounting treatment for inventories. Inventories constitute a major portion of current assets of an entity. A primary issue in accounting for inventories is the amount of cost to be recognized as an asset and carried forward until the related revenues are recognized.

Valuation of inventory is major issue in preparation of financial statements. The value at which inventories are carried in the financial statements, affects the profit and the financial position. AS – 2 deals with the method of valuation of inventories in order to ascertain the correct profit and depict the true state of affair of the enterprise.

Scope: This Statement should be applied in accounting for inventories other than:

a) Work in progress arising under construction contracts, including directly related service contracts [see Accounting Standard (AS) 7, Accounting for Construction Contracts];
b) Work in Progress arising in the ordinary course of business of service providers;
c) Shares, debentures and other financial instruments held as stock-in-trade; and
d) ***Producers' inventories*** of livestock, agricultural and forest products, and mineral oils, ores and gases ***to the extent that they are measured at net realizable value*** in accordance with well-established practices in those industries.

The inventories referred to in (d) above are measured at net realizable value at certain stages of production. This occurs, for example, when agricultural crops have been harvested or mineral oils, ores and gases have been extracted and sale is assumed under a forward contract or a government guarantee, or when a homogenous market exists and there is a negligible risk of failure to sell. These inventories are excluded from the scope of this Statement.

KEY DEFINITIONS

INVENTORY

Inventory comprises of three components:

a) held for sale in the ordinary course of business – i.e., finished goods held for sale by manufacturing entity and goods held by trading entity;
b) in the process of production for such sale – i.e., work in progress; or
c) In the form of materials or supplies to be consumed in the production process or in the rendering of services – i.e., raw material.

NET REALISABLE VALUE (NRV)

NRV 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 estimates are to be based on reliable evidence after taking into consideration price fluctuation or costs directly relating to events after the end of the period to the extent they conform to conditions existing at the end of the period. Contingent losses are to be provided for.

COST OF PURCHASE

Cost of purchase is calculated as follows:

Particulars	**Amount (INR)**
Purchase price	xxx
Add:	
Import Duties and other taxes (e.g. GST) (*to the extent they are not recoverable from the taxing authorities)*	xxx
Freight inwards	xxx
Transport and handling costs and other costs directly attributable to the procurement of goods, material and services	xxx
Less:	
Trade discounts and rebates	(xxx)
Duties and taxes that are subsequently recovered by the enterprise from the taxing authorities	(xxx)
Duty drawbacks and	(xxx)
Other similar items	(xxx)
COST OF PURCHASE	XXX

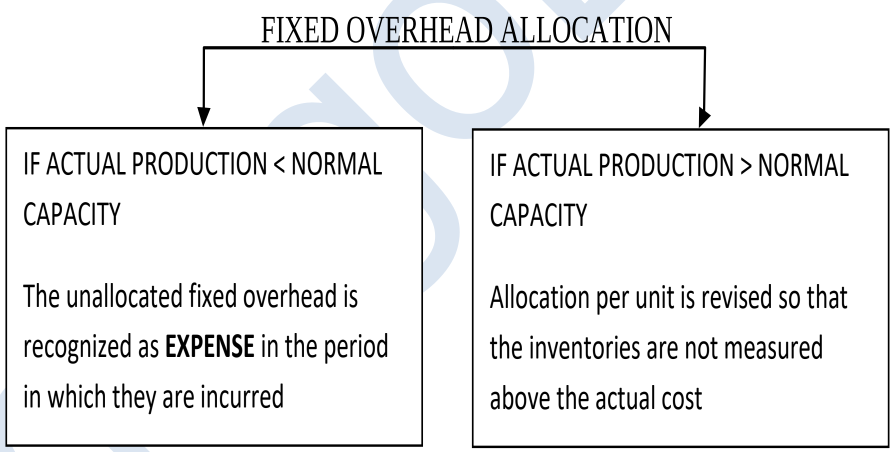
CONVERSION COST

Conversion cost includes 3 major components:

1. Costs directly related to the units of production, such as direct labour, direct material and direct expenses
2. Variable overheads – costs that directly or nearly directly vary with the production e.g., indirect labour and indirect material. These are systematically allocated based on **actual rate per unit**
3. Fixed overheads – the indirect costs which remain relatively constant regardless of the production e.g., depreciation of machinery and factory buildings, insurance of machinery and factory buildings, etc. These are systematically allocated based on **normal capacity.**

   Normal capacity is the production expected to be achieved on an average over number of periods or seasons under normal circumstances taking into account loss of capacity resulting from planned maintenance.

   Since the actual production is not necessarily equal to normal production level, the issue of under and over absorption of overheads needs to be addressed. Two scenarios may arise during the end of each reporting period:



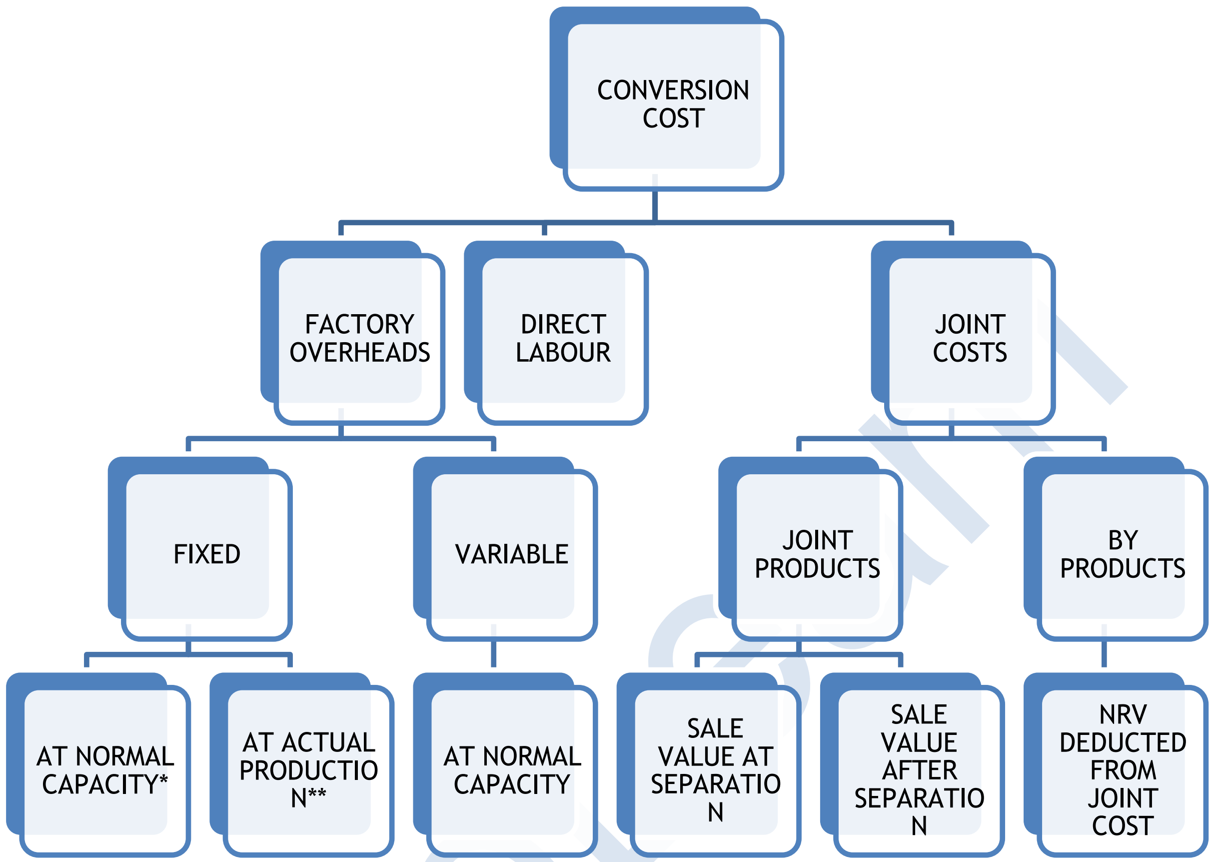

CONVERSION COST
FACTORY OVERHEADS
DIRECT LABOUR
JOINT COSTS
FIXED
VARIABLE
JOINT PRODUCTS
BY PRODUCTS
AT NORMAL CAPACITY*
AT ACTUAL PRODUCTIO N**
AT NORMAL CAPACITY
SALE VALUE AT SEPARATIO N
SALE VALUE AFTER SEPARATIO N
NRV DEDUCTED FROM JOINT COST

Illustration 1:

Normal level of production	1, 00,000 Units.
Fixed production overheads	Rs. 5,00,000 Units.
Actual Production	
Case 1	1,00,000 Units.
Case 2	80,000 Units.
Case 3	1,25,000 Units

Discuss how the fixed production overheads will be allocated to inventory.

Fixed overheads recovery rate = $\frac{\text{Total Fixed Production Overheads}}{\text{Normal level of Production}}$

$= \frac{\text{Rs. } 500000}{100000} = \text{Rs. } 5 \text{ per unit}$

Case	Normal Recovery rate	Recovery rate to be used as per Ind AS 2	Overheads recovered	Overheads treated as period expense	Total overheads
	Rs.	**Rs.**	**Rs.**	**Rs.**	**Rs.**
1	5	5	5,00,000	Nil	5,00,000
2	5	5	4,00,000	1,00,000	5,00,000
3	5	$4 \left\{ \frac{500000}{125000} \right\}$	5,00,000	Nil	5,00,000

In case of joint products, when the costs of conversion of each product are not separately identifiable, they are to be allocated between the products on a rational and consistent basis, e.g., on the basis of relative sales value at split-off point.

Illustration 2:

In a production process, product A and B are jointly produced. A total expenditure Rs.17,50,000 lakhs is incurred as costs of conversion of 50,000 units of A and 25,000 units of B. If the sales value at split-off point is Rs. 50 and Rs. 40 respectively for product A and B, discuss how the cost of conversion will be allocated to products A and B assuming the two products are not separately identifiable.

In case of joint products, if the costs of conversion of each product are not separately identifiable, then such costs should be allocated on some rational basis. Relative sales value at split off point is one such basis. Accordingly, the relative sales value of product A and B works but to be Rs.25 lakhs and Rs.10 lakhs for products A and B respectively. Based on this, the cost of conversion will be allocated between product A and B in the following manner:

Total cost of conversion	Rs. 17,50,000
Total sales value at split-off point	Rs. 35,00,000

Cost of conversion allocated to Product A

= Relative sales value of product A at split off point x Total cost of conversion

Total sales value at split off point (A and b together)

Rs. 2500000 x Rs. 17,50,000

Rs. 3500000

= Rs. 12,50,000

Per unit of conversion = Cost of conversion allocated to product A

No. of units produced (of A)

(Rs. 1250000 / 50,000) = Rs. 25

Cost of conversion allocated to product B

*(*Rs. 1000000 / Rs. 3500000) x Rs.17,50,000 = Rs. 5,00,000

Per unit cost of conversion= (Rs. 500000 / 25,000) = Rs. 20

A. MEASUREMENT AND PRINCIPLES FOR VALUATION OF INVENTORY

FUNDAMENTAL PRINCIPLE OF AS 2 AND IND AS 2: Inventories are required to be stated at the lower of cost and NRV

Therefore, inventory valuation is a three step process:

Step 1 Determine the cost of inventories.

Step 2 Determine the NRV of inventories.

Step 3 Compare the values calculated in step 1 and 2 above.

Lower of the two values is the value of inventories.

STEP 1 – DETERMINE THE COST OF INVENTORIES

Cost of inventories comprise of the following *(REFER DEFINITIONS)*:

a) All costs of purchase.
b) Costs of conversion.
c) Other costs incurred in bringing the inventories to their present condition and location.

STEP 2 – Determine the NRV of inventories

➢ **Example**

	Rs.
Estimated selling price of inventory	10lakhs
Estimated costs of completion	1 lakh
Expenditure required to carry out sale	1.5 lakhs

Calculate NRV

Net Realisable value will be calculated as follows:

	Rs.	**Rs.**
Estimated selling price	10 lakhs	
Less: Estimated costs of completion	1 lakh	
Expenditure required to carry out sale	1.5 lakhs	2.5 lakhs
Net realizable Value (NRV)	7.5 lakhs	

INVENTORY COSTS DO NOT INCLUDE THE FOLLOWING:

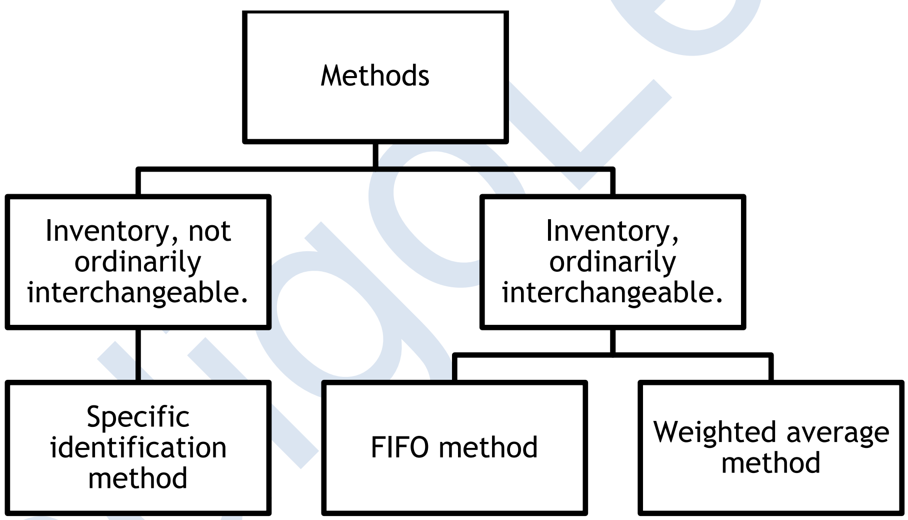
- Abnormal waste

- Storage costs
- Administrative overheads unrelated to production
- Selling costs
- Foreign exchange differences arising directly on the recent acquisition of inventories invoiced in a foreign currency
- Interest cost when inventories are purchased with deferred settlement terms

Interest element vs. cost of inventory: The Standards provides the interest and other borrowing costs are **usually not included.** Under AS 16, interest can be added to the cost of inventories only if specific conditions are fulfilled.

CENVAT Credit & Excise duty vs. cost of inventory: Excise duty paid or payable is an element of cost, and should be included in valuation. However, any amount recoverable from tax authorities by way of Convert credit will have to be considered in the valuation of finished goods items.

What cost formulas can be used to determine the cost of inventories



AS 2 allows cost of inventories to be determined on the basis of following cost formulas:

- Specific identification method.
- FIFO.
- Weighted Average.
- Standard Cost
- Retail Method.

a) **Specific Identification Method:** The method is also known as Specific Price method, Identifiable cost method, etc. This is also known as actual cost method because the specific job bears the actual cost of material bought for the job. When using this method, units in inventory are specifically identified and each unit cost is identified with a particular invoice. In other words, this method tracks the actual physical flow of goods available whether for sale of for production.

Cost of item forming part of inventory, that is **not ordinarily interchangeable as** also for goods or services produced and segregated **for specific projects,** should be assigned by specific identification of their individual costs. This cost formula is particularly suited for automobiles, expensive Jewellery, antique shops or custom made merchandise. This formula has to be applied whenever materials are purchased and set aside for specific job or work order.

b) **First in First out Method:** The method is based on the assumption that the material, which are purchased first, are issued first. Issue of materials is priced in the sequence of incoming order of purchases. The flow of cost of materials should be in the same order. Issues are priced on the same basis until the first lot received is exhausted, after which the price of the next lot received becomes the basis of cost of issues. Thus, the materials issued are priced at the cost pertaining to the earliest lot, and as a corollary the inventory in hand is valued at a price representing recent purchases.

The use of the FIFO does not necessary mean that materials, which were held longest in stock, are physically exhausted first. It merely denotes that cost incurred for the "earliest purchase" is first used for accounting purpose. It is a common practice for most business houses to sell or issue oldest merchandise or materials first so that when FIFO is used for inventory valuation, there is agreement between cost flow assumption and the physical flow of goods. The ending inventory thus would consist of goods recently produced or purchased.

The FIFO method is most successfully used when:

- Size of raw materials is very large and cost is high
- Materials are easily identified as belonging to a particular purchase lot
- Not more than two or three different receipts are on material card at one time
- Price of material does not fluctuate widely, so that clerical labour involved is minimized.
- Materials are subject to deterioration and obsolescence.

c) **Weighted Average Cost (WAC) Method :** WAC is calculated by dividing the total **cost** of material in stock by total **quantity** of material in stock. Under this method, costs are averaged after weighing (i.e., multiplying) by their quantities. The weighted average cost is determined, either at periodical intervals, or each time when fresh materials arrive on purchase. The average cost at any time is, thus, the balance value figure divided by the balance units figure. This method evens out the effect of widely varying prices of different lots of purchases, which make up the stock. There will be no profit or loss arising out of pricing issues.

Application of Rule of Cost or net Realizable Value: This rule can be applied in any of the following ways:

- **Item by item method:** Under this method cost and net realizable value of each and every item is considered individually, and the lower figure is taken for the purpose of inventory valuation.
- **Group method:** (Also known as global method) Under this method similar or related items are grouped into categories and the lower of cost and net realizable value is applied to **each category,** instead of every item forming part of a category. Such a method is adopted **ONLY** in cases of items of inventory relating to the same product line that have similar end-users and are produced and marketed in the same geographical area and cannot be otherwise evaluated separately from other items in that product line.

➢ **Example**

X Ltd. provides you the following list of transactions relating to one of its inventory item PEE. Ascertain the value of inventory of PEE on March 31, 2009:

March, 2009	Particulars	
1	Opening Balance	100 units @ Rs. 25 each
2	Purchased	50 units @ Rs. 30 each
5	Purchased	100 units @ Rs. 28 each
10	Issued	125 units
20	Purchased	150 units @ Rs. 35 each
25	Issued	75 nits

1. Computation of Cost of Closing Stock of PEE Using FIFO

Date March 2009	Receipts			Issues			Balance		
	Qty.	Rate Rs.	Amount Rs.	Qty.	Rate Rs.	Amount Rs.	Qty.	Rate Rs.	Amount Rs.
1	Opening Balance						100	25	2,500
2	50	30	1,500				100 50	25 30	2,500 1,500
5	100	28	2,800				100 50	25 30	2,500 1,500
10				100 25	25 30	2,500 750	25 100	30 28	750 2,800
20	150	35	5,250				25 100 150	30 28 35	750 2,800 5,250
25				25 50	30 28	750 1,400	50 150	28 35	1,400 5,250

Closing Value of Inventory Rs. 6,650

2. Computation of Cost of Closing Stock of Pee using Weighted Average

Date March 2009	Receipts			Issues			Balance		
	Qty.	Rate Rs.	Amount Rs.	Qty.	Rate Rs.	Amount Rs.	Qty.	Rate Rs.	Amount Rs.
1	Opening Balance						100	25.00	2,500
2	50	30	1,500				150	26.67	4,000
5	100	28	2,800				250	27.20	6,800
10				125	27.20	3,400	125	27.20	3,400
20	150	35	5,250				275	31.45	8,650
25				75	34.45	2,360	200	31.45	6,290

Closing Value of Inventory Rs. 6,290

TECHNIQUES FOR MEASUREMENT OF COST

When the cost of inventories cannot be calculated by applying the cost formulas discussed above, then the following two methods can also be used if the results approximate the actual cost.

- **Standard cost method** is used for normal levels of consumption for a given volume of output. It is a pre-determined cost. This method takes into account normal levels of consumption of materials and supplies, labor, efficiency and capacity utilization. These parameters should be regularly reviewed and revised, it necessary, having regard to current conditions.

- The **retail inventory method** is used where the inventories are generally large and volatile. In the retail method, the cost of inventory is determined as under:

  Ascertain sales value of the inventory

  Deduct: Appropriate percentage gross margin

These are typically for valuation of in-process and manufactured items.

For this purpose, the percentage used takes into consideration, inventory which has been marked down to below its selling price. Under this method, an average percentage for each retail department is used.

How is NRV determined?

NRV is calculated as under:

Ascertain estimated selling price in the ordinary cause of business.

Deduct: (a) Estimated cost of completion;

(b) Estimated cost necessary to make the sale.

Inventories should usually be written down to NRV on an item by item basis. However, when the circumstances so require, it may be valued on group basis also.

Estimates of net realizable value should be based on the most reliable evidence available at the time the estimates are made as to the amount the inventories are expected to realize. These estimated should 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.

The purpose for which the inventory is held should also be considered, e.g., the net realizable value of the quantity of inventory held to satisfy firm sales or service contracts is based on the contract price. If the sales contracts are for less inventory is based on general selling prices.

Materials and other supplies held for use in the production of inventories are not written down below cost if the finished products in which they will be incorporated are expected to be sold at or above cost. However, when there has been a decline in the price of materials and it is estimated that the cost of the finished products will exceed net realizable value, the materials are written down to net realizable value. In such circumstances, the replacement cost of the materials may be the best available measure of their net realizable value.

NRV should be estimated at each balance sheet date.

What are the disclosure requirements under AS 2?

a) The accounting policies adopted in measuring inventories, including the cost formula used.
b) the total carrying amount of inventories and its classification appropriate to the enterprise, e.g., raw material and components, work-in-progress, finished goods, stores and spares and loose tools.
c) By virtue of AS 1, an enterprise also need to disclose any change in the accounting policies, adopted in measuring inventories, which has a material effect in the

current period or later period(s) along with its impact on the items of financial statements. Where such impact is not ascertainable, whether wholly or in part, the fact should be disclosed .

Illustration

Illustration 1

Cost of a **partly finished unit** at the end of 2016-17 is Rs. 150. The unit can be finished next year by a **further expenditure** of Rs. 100. Finished unit can be sold at Rs. 250 per unit subject to payment of **4% brokerage on selling price**. Value of inventory is to be determined.

Solution

Workings

1. Brokerage: 4% of Rs. 250 = Rs. 10
2. Net Proceeds from Sale = Rs. 250-Rs. 10 = Rs. 240

Cost of Partly finished unit = Rs. 150
Selling Price = Rs. 250 (-) Estimated Cost of Completion = Rs. 100 (-) Selling Cost (Brokerage) = Rs. 10 **Net Realisable Value = Rs. 140**
Inventory will be valued at Rs. 140 (Lower of cost and NRV)

According to AS-2, Inventory will 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.

Illustration 2

ABC limited has a plant with a **capacity to produce 1,00,000 units** of a product per annum and the expected **fixed overheads is Rs. 18,00,000**. Determine the amount of overheads to be allocated to the inventory in the following cases.

(i) Actual Production is 1,00,000 units
(ii) Actual Production is 90,000 units
(iii) Actual Production is 1,20,000 units

Solution

Explanation

1. Pre-determined Fixed Overhead Recovery Rate

= Rs. 18,00,000/1,00,000

= Rs.18 per unit

2. Case i - Actual Production: 1,00,000 units

If actual production is equal to estimate, pre-determined recovery rate is used.

Overheads allocated = 1,00,000 x Rs. 18 = Rs. 18,00,000

3. Case ii - Actual Production: 90,000 units

If actual production is lower, the recovery rate is not revised.

Overheads allocated = 90,000 X Rs. 18 = Rs. 16,20,000

Rs. 1,80,000 will be charged to P&L

4. Case iii - Actual Production: 1,20,000 units

If actual production is higher, the recovery rate is revised.

Revised overhead recovery rate: Rs.18,00,000/1,20,000 = Rs. 15 per unit

Overheads allocated = Rs. 15 x 1,20,000 = Rs. 18,00,000

Illustration 3

The cost and net realisable value of two items that a company has in its inventory are given below.

Item	Cost (Rs.)	Net Realisable Value (Rs.)
I	50,000	45,000
II	20,000	24,000

Total	**70,000**	**69,000**

Compute the value of inventory.

Solution

Inventory is valued at lower of cost or net realisable value (NRV). Inventory should not be valued on a global basis but on item by item basis.

Item I: Lower of Cost or NRV is Rs. 45,000.

Item II: Lower of Cost or NRV is Rs. 20,000

Total Value of Inventory: Rs. 45,000 + Rs. 20,000 = Rs. 65,000

Illustration 4

X Co. Ltd purchased goods at a **cost of Rs. 40 lakhs** in October 2016. Till March 2017, **75% of the stock was sold.** Company wants to disclose closing stock at Rs. 10 lakhs. Expected **sales value is Rs. 11 lakhs and a commission of 10% is payable** to the agent. Compute the value of Inventory.

Solution

According to AS-2, Inventory will 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.

Selling Price = Rs. 11 lakhs
(-) Selling expenses: 10% of Rs. 11 lakhs = Rs. 11 lakhs
Net Realisable Value = Rs. 9.9 lakhs

The cost of inventory is Rs. 10 lakhs. Hence, the inventory will be valued at Rs. 9.9 lakhs.

Illustration 5

In a production process **normal waste is 5% input**. 5,000 MT of input was put in process resulting in wastage **of 300 MT.** The cost per MT of input is Rs. 1,000. Entire quantity of waste is on stock at year end. With reference to Accounting Standard, How will you value inventories in this case?

Solution:

Normal Wastage: 5,000 X 5% = 250 units
Actual Wastage : 300 units
Abnormal Wastage: 50 Units
Total Cost: Rs. 1,000 X 5000 = Rs. 50,00,000
Allocable units : 5000-250 = 4750 units.
Cost per MT = Rs. 50,00,000/4,750 = Rs. 1052.63 per unit.
Inventory at Hand = 5000-300 = 4700 units
Value of Inventory = 4700 X Rs. 1052.63 = **Rs. 49,47,368/-**
Abnormal Loss = 50 X Rs. 1052.63 = **Rs. 52,632**

Illustration 6

You are required to value inventory per Kg of finished goods.
Material: Rs. 200 per kg
Direct Labour: Rs. 40 per kg
Direct Variable Overhead: Rs. 20 per kg
Fixed production charges for the year on normal working capacity of 2,00,000 Kgs is Rs. 20,00,000.

Solution

Material Cost: Rs. 200
Labour Cost: Rs. 40
Variable Overhead: Rs. 20
Total Variable Cost: Rs. 260
Fixed Overhead: Rs. 10

Cost Per KG: Rs. 270

Working:
Fixed Overhead Recovery Rate: Rs. 20,00,000/2,00,000 = Rs. 10 per Kg

Illustration 7

USA limited purchased raw material at Rs. 400 per Kg. The company does not sell material but uses in production of finished goods. Finished goods in which the raw material is expected to be used are expected to be sold at below cost.

At the end of accounting year, the company is having 10,000 Kgs of raw material in stock. As the company doesn't sell raw material, it doesn't know the selling price of raw material and hence cannot calculate realizable value of material for valuation of inventory. However, replacement cost of raw material is Rs. 300 per kg.

How will you value inventory of raw material?

Solution

According to AS-2, Raw Material is generally valued at Cost. However, if the Finished goods in which raw material are incorporated are expected to be sold below cost, the raw materials are valued at net realisable value. Replacement cost is a measure of realisable value. Hence in this case, Raw Material is valued at realisable value.

Raw Material Inventory

= Rs. 300 X 10,000

= Rs. 30,00,000

Illustration 8

Can PT limited, a wire netting company, while valuing its finished goods at the year end, include interest on bank overdraft as an element of cost for the reason that overdraft has been taken specifically for the purpose of financing current asset like inventory and working capital expenses?

Solution

As per AS-2 Interest and other borrowing costs are usually considered as not relating to bringing the inventories to their present location and condition and are, therefore, usually not included in the cost of inventories. Hence PT limited cannot include interest on bank overdraft as an element of cost.

However, if interest in relation to inventory which is a qualifying asset as per AS-16, interest cost can form part of cost of inventory.

Illustration 9

Knight Limited sells beers to customers. Some of the customers consume the beer in the bar run by Knight Limited. While leaving the bars, consumers leave empty bottle in the bar and the company takes possession of these empty bottles.

The company has laid down a detailed internal control procedure for accounting for these empty bottles which are sold by the company by calling for tenders.

Keeping this in view, decide whether stock of empty bottle is an asset of the company.

If so, whether stock of empty bottles existing as on date of balance sheet is considered to be inventory and is valued as per AS-2 or to be treated as scrap and shown at realisable value with corresponding credit to other income?

Solution

Empty Bottles, generally, would be scrap and valued at Realisable value.

In the given case, Empty Bottles

- have internal control procedure
- Are sold through tenders
- Revenue is important component of revenue

Hence, Empty bottles in this case can be considered as Inventory because of the significance of revenue from these bottles.

Thus, the inventory should be valued at Net Realisable Value.

Illustration 10

Anil Pharma Limited ordered 16,000 Kgs of certain material at Rs. 160 per unit. The purchase price includes excise duty in respect of which full CENVAT credit is admissible.

- Freight incurred amounted to Rs. 140,160.
- Normal Transit Loss is 2%.

The company actually received 15,500 units. The company consumed 13,600 units of material.

Compute cost of inventory under AS-2 and amount of abnormal loss.

Solution

Working Notes

1. Since the price already includes excise duty which is adjustable, the excise duty component would be deducted to arrive at cost of inventory.

2. Freight Inward will form part of cost of inventory

3. Normal Transit Loss – 2% of 16,000 units – 320 units

4. Expected receipt – 16,000 – 320 = 15,680 units

5. Abnormal loss = 15,680 – 15,500 = 180 units.

Particulars	Amount (Rs)
Purchase cost (16,000 X 160)	25,60,000
Less : Cenvat (16,000 X 10)	1,60,000
Add : Freight	1,40,160
Total Cost	**25,40,160**
Expected Units (16,000 – 2% of 16,000)	15,680 units
Cost per unit	$\frac{25,40,160}{15,680}$ = Rs. 162 per unit
Units in Inventory	15,500 – 13,600 = 1,900
Value of Inventory	= 1,900 x Rs. 162 = Rs. 3,07,800
Abnormal Loss (180 units X Rs. 162)	Rs. 29,160

Illustration 11

In a manufacturing process of Vijay Ltd, one by-product BP emerges besides two main products – MP1 and MP2 apart from scrap. Details of cost of production process are hereunder:

Particulars	**Amount (Rs.)**
Raw Material : 15,000 units	1,60,000

Wages	82,000
Fixed Overheads	58,000
Variable Overheads	40,000

Product	**Production Units**	**Closing Stock 31.03.2012**
MP1	6,250	800
MP2	5,000	200
BP	1,600	

Average Market Price of MP1 and MP2 is Rs 80 per unit and Rs. 50 per unit respectively.

By-Product is sold at Rs. 25 per unit. There is a profit of Rs. 5,000 on sale of by-product after incurring separate processing charge of Rs. 4,000 and packing charges of Rs. 6,000.

Rs. 6,000 is realised from sale of scrap.

Calculate the value of closing stock MP1 and MP2 as on 31st March 2012.

Solution

Hint for Exam –

Joint Cost	*Raw Material + Wages + Overheads*
Less:	*NRV of By-product and Scrap*
	Net Joint Cost

Allocate the net joint cost between MP1 and MP2

Particulars	**Amount (Rs.)**
Raw Material Cost	1,60,000
Wages	82,000
Fixed Overhead	58,000
Variable Overhead	40,000

Total Joint Cost	3,40,000
(Less): NRV of by-product [1600X Rs. 25 – Rs. 4000 – Rs. 6000] [40,000-4,000-6,000]	30,000
(Less): NRV of Scrap	6,000
Net Joint Cost	3,04,000

The joint cost of Rs. 3,04,000 must be split between MP1 and MP2 on a reasonable basis. In this case the joint cost can be allocated on relative sale price.

Computation of Sale Value

Product	**Qty**	**Sale Price (Rs.)**	**Sale Value (Rs.)**
MP1	6,250	80	5,00,000
MP2	5,000	50	2,50,000

Allocation of Joint Cost

Joint Cost	**Unit Cost**
MP1 : Rs. 3,04,000 X 2/3 = Rs. 2,02,667	Rs. 2,02,667/6,250 = Rs. 32.42
MP2 : Rs. 3,04,000 X 1/3 = Rs. 1,01,333	Rs. 1,01,333/5,000 = Rs. 20.26

Closing Stock:
MP1 = Rs. 32.42 X 800 = Rs. 25,944/-
MP2 = Rs. 20.26 X 200 = Rs. 4,054/-

Illustration 12

Sun limited has fabricated special equipment (Solar power panel) during 2014-15 as per drawings and design supplied by the customer. However due to a liquidity crunch, the customer has requested the company for postponement in delivery schedule and requested the company to withhold the delivery of finished goods products and discontinue the production of balance items

As a result of the above, the details of the customer balance and the goods held by the company as work in progress and finished goods as on 31-03-2016 are as follows:

Solar Power Panel (WIP) Rs.85 lakhs

Solar Power Panel (Finished goods) Rs.55 lakhs

Sundry Debtor (solar power panel) Rs.65 lakhs

The petition for winding up against customer has been filed during 2015-16 by Sun Ltd.

Comment with explanation on provision to be made on 205 lakh included in Sundry Debtors, Finished goods and work-in-progress in the financial statement of 2015-16.

Illustration 13

A Limited is engaged in manufacturing of Chemical Y for which Raw Material X is required. The company provides you following information for the year ended 31st March, 2017.

Raw Material X	
Cost price Rs.380	Unloading Charges Rs.20
Freight Inward Rs.40	Replacement cost Rs.300
Chemical Y	
Material consumed Rs.440	Variable Overheads Rs.80
Direct Labour Rs.120	

Additional Information:
(i) Total fixed overhead for the year was Rs. 4,00,000 on normal capacity of 20,000 units.
(ii) Closing balance of Raw Material X was 1,000 units and Chemical Y was 2,400 units.

You are required to calculate the total value of closing stock of Raw Material X and Chemical Y according to AS 2, when

(a) Net realizable value of Chemical Y is Rs. 800 per unit
(b) Net realizable value of Chemical Y is Rs. 600 per unit

AS10

1.0 What are Property, Plant and Equipment (PPE)?

Property, Plant and Equipment (PPE) are also generally known as fixed assets; these fixed assets are tangible property in contrast to the intangible property which is dealt by AS-26.

1.1 PPE is tangible items that are:

- held for use in production or supply of goods and services, for rental to others, or for administrative purposes and
- Expected to be used during more than a period of twelve months.

PPE are not held for sale in the normal course of business. Some examples of Property, Plant and Equipment (PPE) are land, building, plant and machinery, furniture and fitting and office equipment etc.

2.0 Scope

This Standard prescribes the accounting for PPE except when another AS permits different accounting treatments. For example AS-19 prescribes a different treatment of assets under Finance Lease.

This Standard does not apply to:

(a) Biological assets related to agricultural activity other than bearer plants. This Standard applies to bearer plants but it does not apply to the produce on bearer plants.
(b) Wasting assets including mineral rights, expenditure on the exploration for and extraction of minerals, oil, natural gas and similar non-regenerative resources.

However, this Standard applies to items of property, plant and equipment used to develop or maintain the assets described in (a) and (b) above.

2.1 Biological asset, Agriculture activity, Agriculture produce and bearer plant

- Biological Asset is a living animal or plant and is core income producing asset of agricultural activity.
- Agricultural activity is the management by an enterprise of the biological transformation and harvest of biological assets for sale or for conversion into agricultural produce or into additional biological assets.

- Agricultural Produce is the harvested product of biological assets of the enterprise.
- Bearer plant is a plant that:

  (a) Is used in the production or supply of agricultural produce;

  (b) Is expected to bear produce for more than a period of twelve months; and

  (c) Has a remote likelihood of being sold as agricultural produce, except for incidental scrap sales.

  The following are not bearer plants:

  1. Plants cultivated to be harvested as agricultural produce (for example, trees grown for use as lumber);
  2. Plants cultivated to produce agricultural produce when there is more than a remote likelihood that the entity will also harvest and sell the plant as agricultural produce, other than as incidental scrap sales (for example, trees that are cultivated both for their fruit and their lumber); and
  3. Annual crops (for example, maize and wheat). When bearer plants are no longer used to bear, produce they might be cut down and sold as scrap, for example, for use as firewood. Such incidental scrap sales would not prevent the plant from satisfying the definition of a bearer plant.

     Example I: Mango tree is a bearer plant and it covered by AS-10 PPE, however mango grown in tree is a produce of bearer plant and is not covered by this Standard. Further in wheat crop the plant of the wheat is not a bearer plant because it is cut down and sold as scrap.

2.2 Investment property is an investment in land or buildings that are not intended to be occupied substantially for use in the operations of the investing enterprise. The investment property is not PPE. However, it should be accounted for only in accordance with the cost model prescribed in this Standard.

3.0 Recognition of assets

Criteria for Recognition - The cost of an item of PPE should be recognized as an asset if and only if:

- it is probable that future economic benefits associated with the asset will flow to the entity and,
- The cost of the item can be measured reliably.

The degree of certainty attached to the flow of future economic benefits must be assessed. This should be based on the evidence available at the date of initial recognition (usually the date of purchase). The entity should thus be assured that it will receive the rewards attached to the asset and it will incur the associated risks, which will only generally be the case when the rewards and risks have actually passed to the entity. Until then, the asset should not be recognized.

Example 2: A plant and machinery is purchased for Rs. 20 lakhs. It satisfied the recognition criteria: future economic benefits will flow to the entity in the form of the capability to produce goods using the machinery, sell them and earn profits. Similarly, its cost can be measured reliably from the purchase invoice. Therefore, it qualifies to be recognized as property, plant and equipment (PPE).

Spare parts which do not meet the criteria of recognition of PPE are usually treated as inventory and recognized in the profit or loss as and when consumed.

Example 3: Small spare parts for machinery are purchased at a cost of Rs. 1.25 lakhs and stored by the entity. These are regularly issued whenever required by the maintenance department.

The balance of the spares on hand at the Balance Sheet date was worth Rs. 70,000. The consumed part of Rs. 55,000 should be shown as an expense in the Statement of Profit and loss. The balance of Rs. 70,000 should be carried forward as inventory it accounting should be as per AS-2.

Major spare parts and standby equipment are treated as property, plant and equipment when they are expected to be used over more than one period. They are included in non-current assets from the date the cost is incurred.

Example 4: Induga Ltd purchased an item of machinery for Rs. 2 lakhs, together with major spare parts worth Rs. 25,000 not readily available in the market. It should recognise the total of Rs. 2.25 lakhs as PPE

Those which can be used exclusively with an item of PPE are accounted for as PPE.

Example 5: Z Ltd purchases a 'made to order' machine for Rs. 5 lakhs and alongside also purchased spare parts worth Rs. 60,000 which can be used only on this machinery and not any machinery elsewhere. Advise Z Ltd on the accounting treatment of spare parts.

Along with the cost of machinery, the cost of spares also, should be capitalised i.e., recognized in the carrying value, thus, the total carrying value is Rs. 5.60 lakhs

Any expenditure incurred that meets the recognition criteria of PPE must be accounted for as an asset (PPE). The Standard makes reference to individually insignificant items that can be aggregated and accounted as a single item of PPE.

However, very often, in practice, entities adopt an accounting policy to expense items that are below a predetermined minimum level in order to avoid undue cost in maintaining the relevant records, which includes tracking the whereabouts of the asset.

The definition and recognition criteria can also be applied to spare parts, although these are often carried as inventory and expensed as and when utilized. However, major spare parts are usually recognized PPE when an entity expects to use them during more than one period.

3.1 Safety and environmental equipment

- The acquisition of such property, plant and equipment, although not directly increasing the future economic benefits of any particular existing item of PPE, may be necessary for an entity to obtain the future economic benefits from its other assets.
- Such items of PPE qualify for recognition as assets because they enable an entity to derive future economic benefits from related assets in excess of what could be derived had those items not been acquired.

For 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 recognized as an asset because without them the entity is unable to manufacture and sell chemicals.

4.0 Initial measurement

An item of property, plant and equipment that qualifies for recognition as an asset should be measured at its cost.

4.1 What is cost of PPE?

The cost of items of PPE comprises of:

- Purchase price, including import duties, non-refundable purchase taxes, less trade discounts and rebates.
- Costs directly attributable to bringing the asset to the location and condition **necessary for it to be used in a manner intended by management.**
- **Initial estimates of cost of dismantling/decommissioning, removing, and site restoration at present value** if the entity has an obligation that it incurs on acquisition of the asset or as a result of using the asset other than to produce inventories.

  AS-29 prescribes the discounting of such provisions and provision is made at present value by applying pre-tax discount rate.

4.2 Directly attributable costs include:

- Employee benefits of those involved in the construction or acquisition of an asset
- Cost of site preparation
- Initial delivery and handling costs
- Installation and assembly costs
- Costs of testing, less the net proceeds from the sale of any product arising from test production
- Borrowing costs to the extent permitted by AS-16, Borrowing Costs
- Professional fees

4.3 Examples of costs that are not directly attributable costs and therefore must be expensed in the income statement include:

- Costs of opening a new facility (often referred to as preoperative expenses)
- Costs of introducing a new product or service including advertising and promotional costs
- Costs of conducting business in a new location or with a new class of customer
- Training costs
- Administration and other general overheads

- Costs incurred while an asset, capable of being used as intended, is yet to be brought into use, is left idle, or is operating at below full capacity
- Initial operating losses
- Costs of relocating or reorganizing part or all of an entity's operations

The income and related expenses of operation that are incidental to the construction or development of an item of PPE should be recognized in the income statement.

For 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 recognized in profit or loss and included in their respective classifications of income and expense.

4.4 Cost of dismantling/decommissioning

- The elements of cost to be incorporated in the initial recognition of an asset are to include the estimated costs of its eventual dismantlement ('decommissioning cost'). That is, the cost of the asset is "grossed up" for these estimated terminal costs, with the offsetting credit being posted to a liability account.

  It is important to stress that recognition of a liability can only be affected when all the criteria set forth in AS-29 for the recognition in provisions are met.

- It seems odd to capitalize decommissioning costs that are not going to emerge until later in the asset's life. However, if there is an obligation as a direct consequence of acquiring or constructing property, plant and equipment to incur further costs in the future that cannot be avoided.
- A provision is recognized in accordance with AS-29. Therefore, the decommissioning costs at the end of the asset's life are just as much a cost of acquiring or constructing the asset as the costs incurred at the start of the asset's life. Decommissioning or similar costs such as dismantling expenditure can often arise in connection with operating leases and leasehold improvements.

4.4.1 For example, the terms of an operating lease may allow the tenant to tailor the property to meet their specific needs by, say, building an additional internal wall, but on condition that the tenant returns the property at the end of the lease in its original state, this will entail dismantling the internal wall.

On building the internal wall, the tenant creates an obligation to remove the wall, which it cannot avoid, therefore, must recognize a provision for that obligation in accordance with AS-29. The cost to the tenant, therefore, of the leasehold improvement is not only the cost of building the wall, but also the cost of restoring the property at the end of the lease by dismantling the internal wall. As such, both costs are capitalised when the internal wall is built and will be recognized in the profit and loss account over the useful life of the asset (generally the expected lease term) as part of the depreciation charge.

4.4.2 Examples of decommissioning costs that may be capitalised as part of the cost of the asset typically arise in oil and gas and electricity industries where environmental damage is caused by, say the construction and commissioning of the facility (for example, the oil platform, as in the example referred to above, or nuclear plant).

Similar costs are incurred in other industries such as: abandonment costs in the mining and extractive industries; clean up and restoration costs of landfill sites and environmental; clean-up costs in the number of industries.

The present value of decommissioning costs will be added to the value of PPE with a corresponding credit to provisions as per AS-29.

4.5 Cost of self-constructed asset

The cost of a self-constructed asset is determined using the same principles as for an acquired asset. If an entity 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 (AS-2). ***Therefore, any internal profits are eliminated in arriving at such costs***.

The 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. AS-16 Borrowing Costs establishes criteria for the recognition of interest as a component of the carrying amount of a self-constructed item of property, plant and equipment.

4.6 Exchange of assets

AS-10 specifies that exchange of items of PPE, regardless of whether the assets are similar, are measured at fair value, unless:

1. the exchange transaction lacks commercial substance, or
2. The fair value of neither the asset given up and nor the asset acquired can be measured reliably.

If the acquired item is not measured at fair value, its cost is measured at the carrying amount of the asset given up.

Whether an exchange transaction has commercial substance depends on the extent to which the reporting entity's future cash flows are expected to change as a result of the transaction. If the expected cash flows after the exchange of assets are different from what would have been without the exchange, the exchange has commercial substance and is to be accounted for at fair value.

If the transaction does not have commercial substance, or the fair value of neither the asset received nor the asset given up can be measured reliably, then the asset acquired is valued at the carrying amount of the asset given up less settle-up paid or received in cash or a cash equivalent.

4.7 Measurement of cost

The cost of an item of PPE is the cash price equivalent at the recognition date. If payment is deferred beyond normal credit terms, the difference between the cash price equivalent and the total payment is recognized as interest over the period of credit unless such interest is capitalised in accordance with AS-16.

The cost of an item of PPE held by a lessee under a finance lease is determined in accordance with AS-19.

4.8 Cost of Bearer Plants

Bearer plants are accounted for in the same way as self-constructed items of property, plant and equipment before they are in the location and condition necessary to be capable of operating in the manner intended by management. **"Construction"** should be read as covering activities that are necessary to cultivate the bearer plants before they are in the location and condition necessary to be capable of operating in the manner intended by management.

5.0 Subsequent costs

- the issue is whether subsequent expenditure is capital expenditure (i.e., to the Balance Sheet) or revenue expenditure (i.e., profit or loss statement.

- The cost of the day-to-day servicing of an item PPE is not recognised as cost of PPE. These costs are recognized in statement of profit and loss as incurred. 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 these expenditures is often described as for the 'repairs and maintenance' of the item of property, plant and equipment.

- To qualify for capitalization, cost must be associated with incremental benefit for example, modification to the asset made to extend its useful life or to increase its capacity would be capitalised. Similarly if the expenditure results in an improve quality of output or results in saving the cost it will qualify for capitalization.

5.1 Part replacement

- Some items (e.g. aircraft, ships, gas, turbine etc.) are series of linked parts which require regular replacement at different intervals and so have different useful lives.
- The cost of such regular replacement is capitalised, if the recognition criteria are met.
- The carrying amount of replaced parts (old parts) is derecognized (i.e., treated as a disposal)

5.2 Major inspection/ overhaul costs

- Performing regular major inspections for faults, regardless of whether parts of the item are replaced, may be a condition of continuing to operate an item of PPE (e.g. an aircraft).
- The cost of each major inspection performed is recognized in the carrying amount (capitalised), as a replacement, if the recognition criteria are satisfied.
- Any remaining carrying amount of the cost of the previous inspection (as distinct from physical parts) is derecognized.

5.4 Subsequent Measurement

An entity may choose between the cost model and the revaluation model for subsequent measurement of items of PPE. However, the same policy must be applied to entire class of PPE.

The following are examples of separate classes of PPE:

(a) Land;

(b) Land and buildings;

(c) Machinery;

(d) Ships;

(e) Aircraft;

(f) Motor vehicles;

(g) Furniture and fixtures;

(h) Office equipment; and

(i) Bearer plants.

5.4.1 Cost Model: An item of PPE is carried at cost less any accumulated depreciation and any accumulated impairment losses.

5.4.2 Revaluation Model

At item of PPE is carried at a revalued amount, being fair value at the date of the revaluation less any subsequent accumulated depreciation and any accumulated impairment losses. An enterprise should apply this model only if fair value can be measured reliably.

5.4.2.1How is fair value determined?

The fair value of items of property, plant and equipment is usually determined from market-based evidence by appraisal that is normally undertaken by professionally qualified values.

If there is no market based evidence of fair value (e.g. because items are of a specialized nature or rarely sold), fair value is estimated using depreciated replacement cost; or an income approach (based on discounted future cash flows).

What is the frequency of revaluation?

- 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.
- Frequency depends on movements in fair values. When fair value differs materially from carrying amount, a further revaluation is necessary.
- Items within a class may be revalued on a rolling basis within short period of time provided revaluations are kept up to date.

At the date of revaluation, the asset is treated in one of the following ways:

- Gross carrying amount is adjusted in a manner that is consistent with the revaluation of the carrying amount of the asset. The 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

E.g. The PPE is recorded at cost of Rs. 1000 and has an accumulated depreciation of Rs. 400 on the date of revaluation. The PPE is considered to have a fair value of Rs. 1,500 on the date of revaluation. *In this case the revaluation gain is Rs. 900 which is proportionately adjusted against gross carrying amount and depreciation.*

If Rs. 600 (net carrying amount on date of revaluation) is to be restated as 1,500 then the gross carrying amount becomes Rs.1,500/600 X 1000 = Rs. 2,500. The accumulated depreciation is shown at Rs. 1,000 so that the net carrying amount after revaluation becomes Rs. 1,500

- Accumulated depreciation is eliminated against gross carrying amount of the asset.

  In the above example, the revaluation gain of Rs. 900 would be first adjusted against accumulated depreciation. The accumulated depreciation of Rs. 400 will be shown at Nil. The balance of Rs. 500 will be added to gross carrying amount. The gross carrying amount would be shown at Rs. 1,500.

Increase/decrease due to revaluation

On an asset by asset basis:

- Increase should be credited directly to owners' interests under the heading of **Revaluation Surplus** in the Balance Sheet. However a revaluation increase must be recognized in profit and loss to the extent that it reverses a revaluation decrease of the asset that was previously recognized as an expense.
- Decrease should be recognized as an expense in profit and loss. However, a revaluation decrease must be charged directly against any related revaluation surplus, to the extent that it is covered by that surplus.
- The revaluation surplus may be transferred directly to retained earnings when the surplus is realized (e.g., on disposal of the asset or during the asset's remaining useful life)

5.5 Changes in existing Decommissioning, Restoration and Other Liabilities

The cost of property, plant and equipment 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 and included in the cost of asset.

5.5.1 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.
- The amount deducted from the cost of the asset cannot 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, the enterprise should consider whether this is an indication that the new carrying amount of the asset may not be fully recoverable. 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 AS 28

5.5.2 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.

(a) Any decrease in liability is credited to Revaluation Surplus. However, if a revaluation deficit was recognised earlier, the decrease in liability will be credited to profit and loss account.
(b) An increase in the liability should be debited in statement of profit and loss. If revaluation surplus exists on that asset it should be debited to revaluation surplus to the extent of upward revaluation earlier.

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 recognized immediately in the statement of profit and loss.

6.0 Depreciation

- Depreciable amount should be allocated on a systematic basis over useful life.
- Useful life and residual value must be reviewed at least at each financial year end. If expectations differ from previous estimates the changes are to 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" (i.e., adjusting depreciation charge for current and future periods).
- Depreciation method should reflect the pattern in which the asset's economic benefits are consumed.
- Depreciation charge for each period should be recognized as an expense unless it is included in the carrying amount of another asset.
- AS-10 does not specify a method to be used.

AS-10 requires that each part of an item of PPE that has a cost that is significant when compared to the total cost of the item should be depreciated separately:

- For example, it may be appropriate to depreciate separately airframe and engines of an aircraft.
- Where one significant part has a useful life and a depreciation method that is the same as those of another part of the same item of PPE, the two parts may be grouped together for depreciation purpose.
- Standard allows separate depreciation on remaining parts that are not significant individually in terms of their cost compared to the total cost of an item.

6.1 Depreciable amount- The Depreciable amount of an Asset shall be allocated on a systematic basis over its useful life.

Factors to be considered:

- Expected usage assessed by reference to expected capacity or physical output;
- Expected physical wear and tear (depends on operational factors e.g. number of shifts, repair and maintenance programme, etc.)
- Technical obsolescence arising from changes or improvements in production; or changes in market demand for product or service output.
- Legal or similar limits on the use (e.g., expiry dates of related leases).
- Repair and maintenance policies may also affect useful life (e.g., by extending it or increasing residual value) but do not negate the need for depreciation.

6.3 Residual value

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. In other words it is value which would be obtained presently assuming the asset at end of life would be sold today.

- Depreciable amount is net of residual value. Residual value is often insignificant and immaterial to the calculation of the depreciable amount.

Depreciation is always recognized, even if fair value exceeds carrying amount, except when residual value is greater than carrying amount (in which case the depreciation charge is zero).

6.4 Depreciation period

- Depreciation commences when an asset is available for use.
- Depreciation ceases at the earlier of the date the asset is:
  - retired from active use
  - held for disposal
- Depreciation does not cease when an asset is idle or retired from use for sale (unless it is fully depreciated). However, depreciation may be zero under the "units of production method".

6.4.1 Land and buildings

- These are separable assets and are separately accounted for, even when they are acquired together:
- Land normally has an unlimited useful life and is therefore not depreciated. Buildings normally have a limited useful life and are depreciable asset.
- Where land has a limited useful life (e.g., a landfill site, mine, quarry) it is depreciated.

6.5 Depreciation methods

Straight line - a constant charge over useful life

Diminishing balance - a decreasing charge over useful life

Sum of the units - charge based on expected use or output.

6.5.1 Review of depreciation method –

The depreciation method is reviewed periodically and, if significant, the method is changed to reflect a change in pattern of consumption of future benefits. A change in method of depreciation is accounted for as a change in accounting estimate according to AS-5.

The depreciation method should also be reviewed at least of each financial year end and, if there has been a significant change in the expected pattern of consumption of the future economic benefits from those assets, the method should be changed to suit this changed pattern. When such a change in depreciation takes place the change should be accounted for as a change in accounting estimate and the depreciation charge for the current and future periods should be adjusted.

6.5.2 Depreciation as per Schedule II of the Companies Act, 2013 and Guidance Note thereon:

- As per Schedule II of the Companies Act, 2013, depreciation to be charged on the basis of useful life of asset. Revised AS-10, Property, Plant and Equipment (PPE) also prescribe the same principle of useful life.
- The Schedule II prescribes that the useful life of an asset shall not ordinarily be different from the useful life specified in the Schedule and the residual value of an asset shall not be more than 5% of the original cost of the asset.
- Where a company adopts a useful life different from what is specified in the Schedule or uses a residual value different from the limit specified

above, the financial statements shall disclose such difference and provide justification in this behalf duly supported by technical advice.

6.5.3 Component Accounting

- As per note 4 Schedule II to the Companies Act, 2013 -“Useful life specified in Part C of the Schedule is for whole of the asset.
- Where cost of a part of the asset is significant to total cost of the asset and useful life of that part is different from the useful life of the remaining asset, useful life of that significant part shall be determined separately.
- The above requirement is commonly known as 'component accounting’. Companies will need to identify and depreciate significant components with different useful lives separately. The revised AS-10, Property, Plant and Equipment (PPE) also prescribe the component accounting.
- The determination as to whether a part of an asset is significant requires a careful assessment of the facts and circumstances. This assessment would include at a minimum:

  - comparison of the cost allocated to the item to the total cost of the aggregated property, plant and equipment; and
  - Consideration of potential impact of componentization on the depreciation expense.

Component accounting requires a company to identify and depreciate significant components with different useful lives separately. The application of component accounting is likely to cause significant change in the measurement of depreciation.

As component accounting was hitherto not mandatory in India, it is possible that the separate cost of each significant component of an asset is not available in the books of account. In order to determine the cost of such component following criteria can be used:

1. Break up cost provided by the vendor
2. Cost break up given by internal/external technical expert
3. Current replacement cost of component of the related asset and applying the same basis on the historical cost of asset

The first step is to identify key components requiring separate depreciation. Schedule II requires separate depreciation only for parts of an item of tangible fixed asset having:

- Significant cost, and
- Different useful lives from remaining parts of the asset.

The company must split the fixed asset into various identifiable parts to the extent possible. The identified parts should be grouped together if they have the same or similar useful life for the purpose of separate depreciation. Insignificant parts may be combined together in the remainder of the asset or with the principal asset.

For instance:

(a) A Building may be split up into the following components:

- Structural design
- Elevators
- Heating system
- Water system
- Electrical system

(b) A Ship may be bifurcated into the following components:

- Hull
- Kee
- Engine
- Navigation system
- Major overhaul/inspections
- Other fit out assets

  Identification of significant parts is a matter of judgment and decided on case-to- case basis. Identification of separate parts of an asset and determination of their useful life is not merely an accounting exercise; rather, it involves technical expertise. Hence, it may be necessary to involve technical experts to determine the parts of an asset.

  A company needs to identify only material/significant components separately for depreciation. Materiality is a matter of judgment and needs to be decided on the facts of each case. For example, a component having original cost equal to or less than 5% of the original cost of an asset may not be material. Similarly, a component having original cost equal to 25% or more of the original cost of complete asset may be material. The Company may consider 10% of original cost of the asset as a threshold to determine whether a component is material /significant.

In addition, a company also needs to consider impact on retained earnings, current year profit or loss and future profit or loss (say, when part will be replaced) to decide materiality. If a component may have material impact from either perspective, the said component will be material and require separate identification.

Each significant component of the asset having useful life, which is different from the useful life of the remaining asset, should be depreciated separately. If the useful life of the component is lower than the useful life of the principal asset as per Schedule II, such lower useful should be used. On the other hand, if the useful life of the component is higher than the useful life of the principal asset as per Schedule II, the company has a choice of using either the higher or lower useful life. However, higher useful life for a component can be used only when management intends to use the component even after expiry of useful life for the principal asset.

To illustrate, assume that the useful life of an asset as envisaged under the Schedule II is 10 years. The management has also estimated that the useful life of the principal asset is 10 years. If a component of the asset has useful life of 8 years, AS-10 requires the company to depreciate the component using 8 year life only.

However, if the component has 12-year life, the company may depreciate the component using either 10-year life as prescribed in the Schedule I

7 Impairment

♦ to determine whether an item of PPE is impaired an entity applies AS-28, Impairment of Assets.

♦ Impairment losses are accounted for accordance with AS-28.

♦ In certain circumstances a third party will compensate an entity for an impairment loss. For example, insurance for fire damage or compensation for compulsory purchase of land for a motorway. Such compensation must be included in profit or loss when it becomes receivable.

♦ Recognizing the compensation as deferred income or deducting it from the impairment loss or from the cost of a new asset is not appropriate.

De-recognition: Accounting treatment

♦ In Balance Sheet: Eliminate on disposal or when no future economic benefits are expected from use ("retirement") or disposal.

♦ Statement of Profit and Loss: Recognize gain or loss (difference between estimated net disposal proceeds and carrying amount) in profit or loss unless a sale and leaseback (AS-19).

♦ Gains are not classified as revenue.

De-recognition date

♦ The revenue recognition principle in AS - 9 Revenue Recognition, for sales of goods applies also to sales of items of PPE only to determine the date of sale.

Disclosure

For each class

- Measurement bases used for determining gross carrying amount.
- Depreciation method used.
- Useful lives or the depreciation rates used.
- Gross carrying amount and accumulated depreciation at beginning and end of period. Accumulated impairment losses are aggregated with accumulated depreciation.
- A reconciliation of carrying amount at beginning and end of period showing:
    - Additions (i.e., capital expenditure);
    - Assets retired from active use and classified as held for sale and other disposals;
    - Acquisitions through business combinations;
    - Increase/decrease resulting from revaluations;
    - Impairment losses (i.e., reductions in carrying amount);
    - Reversal of impairment losses;
    - Depreciation;
    - Net exchange differences arising on translation of functional currency into reporting currency;
    - Other movements, in case of translation of a foreign operation.
    - Others

Other Disclosures

- Existence and amounts of restrictions on title, and PPE pledged as security
- Expenditures on account of PPE in course of construction.
- Contractual commitment for the acquisition of PPE.
- Compensation from third parties for items impaired, lost or given up that is included in profit or loss, if not disclosed separately in the statement of Profit and Loss.

Items stated at revalued amounts

- Effective date of revaluation.
- Whether an independent value was involved.
- Methods and significant assumptions applied to estimate fair values.
- The extent to which fair values were

    - determined directly (i.e., by reference to observable prices in an active market or recent market transactions on arm's length terms) or
    - Estimated using other valuation techniques. For example, indices may be used to determine replacement cost.
- Carrying amount of each class of PPE that would have been included in the financial statements had the assets been carried under the cost model.
- Revaluation surplus, indicating movement for period and any restrictions on distribution of balance to shareholders.

Disclosure encouraged

- Carrying amount of temporarily idle PPE.
- Gross carrying amount of any fully depreciated PPE that is still in use.
- Carrying amount of PPE retired from active use and not classified as held for sale.
- When the cost model is used, the fair value of PPE when this is materially different from the carrying amount.

Transitional Provisions

- Where an entity has in past recognized expenditure in the statement of profit and loss which is eligible to be included as a part of the cost of a project for construction of property, plant and equipment in accordance with AS-10 (Revised), it may do so retrospectively for such a project. The effect of such retrospective application of this requirement should be recognised net-of-tax in revenue reserves.
- The requirements regarding the initial measurement of an item of PPE acquired in an exchange of assets transaction should be applied prospectively only to transactions entered into after this Standard becomes mandatory.
- On the date of this Standard becoming mandatory, the spare parts, which hitherto were being treated as inventory under AS-2, Valuation of Inventories, and are now required to be capitalised in accordance with the requirements of this Standard, should be capitalised at their respective carrying amounts. The spare parts so capitalised should be depreciated over their remaining useful lives prospectively as per the requirements of this Standard.
- The requirements regarding the revaluation model should be applied prospectively. In case, on the date of this Standard becoming mandatory, an enterprise does not adopt the revaluation model as its accounting policy but the carrying amount of item(s) of PPE reflects any previous revaluation it should adjust the amount outstanding in the revaluation reserve against the carrying amount of that item. However, the carrying amount of that item should never be less than residual value. Any excess of the amount outstanding as revaluation reserve over the carrying amount of that item should be adjusted in revenue reserves.

Illustrations

Illustration 1

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 re-modelling and the expectation of a 15% increase in sales resulting from the store renovations, which will attract new customers. State whether the re-modelling cost will be capitalized or not.

Solution

The cost of an item of PPE should be recognised as an asset if, and only if:

(a) It is probable that future economic benefits associated with the item will flow to the enterprise, and

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

The expenditure in re-modelling the store will create future economic benefits (in the form of 15% of increase in sales) and the cost of re-modelling can be measured reliably, therefore, it should be capitalized.

Illustration 2

What happens if the cost of the previous part / inspection was / was not identified in the transaction in which the item was acquired / constructed?

Solution

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

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.

Illustration 3

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 capitalized into the cost of the new building?

Solution

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.

The costs to be incurred by the company are in the nature of costs of relocating or reorganizing operations of the company and are not necessary for bring the asset to the location and condition as 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.

Illustration 4

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 re-modelling 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

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 claims 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 capitalized. Comment.

Solution

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 should be capitalised. Costs incurred after the asset is ready to use are not capitalised.

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 should be expensed as incurred.

Illustration 6

Entity A exchanges surplus 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?

Solution

When Property, Plant & Equipment is acquired in exchange of another asset and the transaction has a commercial substance, the PPE acquired is measured at fair value.

The plant and machinery acquired in this case will be measured at Rs. 25,00,000.

**The value of land realized in this case is Rs. 45,00,000 [Plant and Machinery Rs. 25,00,000 and Cash Rs. 20,00,000]*

Illustration 7

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

When Property, Plant & Equipment is acquired in exchange of another asset and the transaction has a commercial substance, the PPE acquired is measured at fair value. If the transaction lacks commercial substance, the acquired items are measured at book value of assets given up.

Book Value of Car X – Rs. 13,00,000

Less: Cash Received- Rs. 15,000

Value of Car Y = Rs. 12,85,000

Illustration 8

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 industry

ial 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

A company can choose to apply cost model or revaluation model to measure PPE and must apply a single policy to a class of PPE. A class of PPE is a grouping of assets of a similar nature and use in operations of an enterprise.

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. Hence, Entity A's management can apply the revaluation model only to the office buildings.

However, all properties within the class of office buildings must be carried at revalued amount.

Illustration 9

Entity A has a policy of not providing for depreciation on PPE capitalized 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 10

Entity A purchased an asset on 1st January 2013 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 2017, 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

Particulars	Amount in Rs
Depreciation for years 1-4	Rs.10000 x 4 = Rs.40,000
WDV at beginning of year 5	Rs.1,00,000- Rs.40,000 = Rs.60,000
Balance useful life	4 years
Depreciation for balance useful life	Rs.60,000 / 4 = Rs.15,000 per year

Illustration 11

Entity B constructs a machine for its own use. Construction is completed on 1st November 2016 but the company does not begin using the machine until 1st March 2017. Comment when should the entity start charging depreciation.

Solution

The entity should begin charging depreciation from the date the machine is ready for use - that is, 1st November 2016.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.

Illustration 12

A property costing Rs.10,00,000 is bought in 2016. 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 2016 prices, is:

Case (a) Rs.10,00,000 Case (b) Rs.9,00,000.

Calculate the amount of depreciation.

Solution

Case a	
Cost of Property	Rs. 10,00,000
Less : Estimated Salvage Value	Rs. 10,00,000
Depreciable Amount	Nil
Depreciation	Nil

Case b	
Cost of Property	Rs. 10,00,000
Less : Estimated Salvage Value	Rs. 9,00,000
Depreciable Amount	Rs. 1,00,000
Useful Life	20 Years
Depreciation	Rs. 1,00,000 / 20 = Rs. 5,000

Illustration 13

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 the Rs.20,00,000 as cash compensation. State, how Entity A should account for the same.

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 recognize 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.

Particulars	Debit	Credit
Profit & Loss Account Dr. To Plant & Machinery Account (Being loss on account of fire)	2,00,000	2,00,000
Insurance Company Account Dr. To Profit & Loss Account (Being claim settlement by insurance company)	20,00,000	20,00,000
Plant & Machinery Account Dr To Insurance Company Account (Being plant received from insurance company)	20,00,000	20,00,000

Illustration 14

ABC Ltd. is installing a new plant at its production facility. It has incurred these costs:

#	**Particulars**	**Amount(Rs.)**
1	Cost of the plant (cost per supplier's invoice plus taxes)	25,00,000
2	Initial delivery and handling costs	2,00,000
3	Cost of site preparation	6,00,000
4	Consultants used for advice on the acquisition of the plant	7,00,000
5	Interest charges paid to supplier of plant for deferred credit	2,00,000
6	Present Value Estimated dismantling costs to be incurred after 7 years	3,00,000
7	Operating losses before commercial production	4,00,000

Please advise ABC Ltd. on the costs that can be capitalized in accordance with AS 10 (Revised).

Solution

According to AS-10 (Revised), the cost of an item of property, plant & equipment comprises its purchase price, all taxes (other than those refundable or eligible as input tax credit) and 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. The initial estimates of dismantling costs must be capitalized at their present values. Initial operating losses do not form part of cost of property, plant and equipment.

S.No.	Particulars	Capitalisation	Amt (Rs.)
1	Cost of the plant (cost per supplier's invoice plus taxes)	**Yes**	25,00,000
2	Initial delivery and handling costs	**Yes**	2,00,000
3	Cost of site preparation	**Yes**	6,00,000
4	Consultants used for advice on the acquisition of the plant	**Yes**	7,00,000
5	Present Value Estimated dismantling costs to be incurred after 7 years	**Yes**	3,00,000
	Total Cost to be capitalized		43,00,000

Interest charges paid to suppliers will not be capitalized unless the asset is a qualifying asset as defined by AS-16.

Illustration 15

A Ltd. has an item of plant with an initial cost of Rs.1,00,000. At the date of revaluation, accumulated depreciation amounted to Rs.55,000. The fair value of the asset, by reference to transactions in similar assets, is assessed to be Rs. 65,000. Pass Journal Entries with regard to Revaluation.

Particulars	Debit Amount	Credit Amount
Accumulated depreciation A/c Dr. **To Asset A/c** (Being elimination of accumulated depreciation against the cost of the asset)	55,000	 55,000

Asset A/c **To Revaluation Surplus A/c** (Being increase of net asset value to Fair value)	**Dr.**	20,000	 20,000

Illustration 16

B Ltd. owns an asset with an original cost of Rs. 2,00,000. On acquisition, management determined that the useful life was 10 years and the residual value would be Rs 20,000. The asset is now 8 years old, and during this time there have been no revisions to the assessed residual value.

At the end of year 8, management has reviewed the useful life and residual value and has determined that the useful life can be extended to 12 years in view of the maintenance program adopted by the company. As a result, the residual value will reduce to Rs.10,000.

How would the above changes in estimates be made by B Ltd?

Solution

Depreciable amount = 2,00,000 – 20,000
= 1,80,000

Annual Depreciation Amount =(1,80,000/10)
=18,000

Total Deprecation Debited =18,000 x 8
=1,44,000

Carrying Amount of Asset at end of 8 Years =2,00,000 – 1,44,000
=56,000

Asset can be used for 4 more years.

Revised Depreciation =(56,000 -10,000) / 4
=11,500

Illustration 17

An entity bought a plot of land for development of office buildings. Development of the land was scheduled into six phases. The land scheduled for development in phases five and six was leased to another entity on a short-term basis as a parking lot for heavy vehicles.
What is the treatment of rental income from car parking lot?

Solution

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.

In the given case the land scheduled for development was leased on a short term basis as a parking lot for heavy vehicles. The car park activity is incidental to the entityRs.s principal activity of property development. The income and related expenses of incidental operations are recognized in the Statement of Profit and Loss for the period.

Illustration 18

An entity acquires the right to use an underground cave for gas storage purposes for a period of 50 years. The cave is filled with gas, but a substantial part of that gas will only be used to keep the cave under pressure in order to be able to get gas out of the cave. It is not possible to distinguish the gas that will be used to keep the cave under pressure and the rest of the gas. Evaluate whether AS 10 would apply or AS 2.

Solution

The total volume of gas must be virtually split into

(i) Gas held for sale, and

(ii) Gas held to keep the cave under pressure.

The former must be accounted for under AS 2 as Inventories. The latter must be accounted for as PPE under AS 10 and depreciated over the period the cave is expected to be used.

Illustration 19

In the year 2018-19, an entity has acquired a new freehold building with a useful life of 50 years for Rs. 75,00,000. The entity desires to calculate the depreciation charge per annum using a straight-line method. It has identified the following components (with no residual value of lifts & fixtures at the end of their useful life) as follows

Component Useful life (Years) Cost	Useful life (Years)	Cost
Land	Infinite	Rs. 10,00,000
Roof	25	Rs. 15,00,000
Lifts	20	Rs. 7,50,000
Fixtures	10	Rs. 2,50,000
Remainder of building	50	Rs. 40,00,000
		Rs. 75,00,000

Calculate depreciation for the year 2018-19 as per componentization method. Also state the treatment, in case Roof requires replacement at the end of its useful life

Illustration 20 (RTP Nov 2019)

Shrishti Ltd. contracted with a supplier to purchase machinery which is to be installed in its Department A 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 foundations were Rs. 1,41,870. These activities were supervised by a technician during the entire period, who is employed for this purpose of Rs.45,000 per month. The technician's services were given by Department B to Department A, which billed the services at Rs. 49,500 per month after adding 10% profit margin.

The machine was purchased at (Rs.1,58,34,000 inclusive of IGST @12% for which input credit is available to Shrishti Ltd. Rs. 55,770 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.

Also, payment under the invoice was due in 5 months. However, the Company made the payment in 3rd month. The company operates on Bank Overdraft @ 14% p.a.

Ascertain the amount at which the Machinery should be capitalized under AS 10.

AS 11

1.0 : The Scope of the Standard:

AS 11 (Revised 2003) is to be mandatorily applied by an enterprise:

i. In accounting for transactions in foreign currencies;

ii. In translating the financial statements of foreign operations;

iii. In accounting for foreign currency transactions in the nature of forward exchange contracts (except the ones that are entered into hedge the foreign currency risk of a 'firm commitment' or 'highly probable forecast transaction')

However, the standard is not applicable to:

i. The restatement of the enterprise's financial statements from its reporting currency into another currency for the users accustomed to that currency or for similar purpose.

ii. The presentation in a cash flow statement of cash flows arising from transactions in a foreign currency and the translation of cash flow of a foreign operation.

iii. Exchange differences arising from foreign currency borrowings to the extent that they are regarded as an adjustment to interest costs (covered by AS-16)

iv. Exchange differences arising on a forward exchange contract entered into to hedge the foreign currency risk of a 'firm commitment' or 'a highly probable forecast transaction' (A 'firm commitment' as a binding agreement for the exchange of a specified quantity of resources at a specified price on a specified future date or dates whereas a 'forecast transaction' is an uncommitted but anticipated future transaction.)

2.0 : Terms that have been defined in the standard:

Exchange Rate: Exchange rate is the ratio for exchange of two currencies (e.g. if $ = Rs. 50, it means that one US dollar can be exchanged for 50 Indian rupees) as applicable to the realization of a specific asset or the payment of a specific liability or the recording of a specific transaction or a group of inter-related transactions.

Average Rate: Average rate is the mean of exchange rates in force during a period,

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

Closing Rate: Closing rate is the exchange rate at the balance sheet date.

Spot exchange rate is the exchange rate for immediate delivery

Monetary Items: Monetary items are money held and assets and liabilities to be received or paid in fixed or determinable amounts of money, e.g., cash, receivables, payables.

Long term monetary items are monetary items having a maturity of 12 months or more from the date of initial recognition of asset or liability.

Non-monetary Items: Non-monetary items are assets and Liabilities other than monetary items e. g., fixed assets, inventories, investments in equity shares.

Reporting Currency: Reporting currency is the currency used in presenting the financial statements, e.g., Rupee will be the reporting currency to be used in presenting the financial statements in India.

Foreign Currency: Foreign currency is a currency other than the reporting currency of an enterprise, e.g., if a branch of an Indian Company is located in US then dollar will be the foreign currency.

Exchange Difference: Exchange difference is the difference resulting from reporting the same number of units of a foreign currency in the reporting currency at different exchange rate.

Fair Value: 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.

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

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

Integral Foreign Operation: Integral foreign operation is a foreign operation, the activities of which are an integral part of those of the reporting enterprise.

Non-integral foreign operations is a foreign operation that is not an integral foreign operation

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

Foreign Currency Transactions: Transactions denominated in a foreign currency or those that require settlement in a foreign currency are called foreign currency transactions.

3.0 : Foreign Currency Transactions:

a) **Initial Recognition:** Transactions involving foreign currencies can be brought under four groups, namely,

   (a) Buying or selling of goods and services,
   (b) Borrowing or lending money,
   (c) Acquiring or disposing of assets, or incurring and settling liabilities, or
   (d) By being a party to a forward exchange contract.

   For initial recognition, the Accounting Standard prescribes ***that a foreign currency transaction should be recorded by applying the exchange rate at the date of the transaction***.

   Note: For practical reasons, an average rate for day/ a week/ month may be used, if the fluctuations are not high

b) **Reporting at subsequent Balance sheet date:** For the purpose of showing the effect of change in foreign exchange rates, the transactions are classified into monetary items and non-monetary items. At each balance sheet date:

Type	***Reporting Rate***
Monetary Item	Closing Rate

Non-Monetary Item carried at historical cost (e.g. Fixed Assets)	Exchange Rate on date of transaction
Non-Monetary items carried at fair value	Exchange Rates that existed when the fair values were determined.

C.**Recognizing exchange difference:** Exchange differences can arise on three counts:

- A transaction – either a monetary item, or a non-monetary item – being ***settled at a rate different from the rate at which it was initially recorded (Settlement in the same accounting period)***.

- A transaction ***being reported at a rate different from the rate at which it was either initially recorded (balance sheet reporting)***.

- A transaction being ***settled as a rate different from the one taken for reporting in the last financial statement (settlement in different accounting period)***.

<u>Accounting for Exchange Differences</u>

<u>Option I</u>: Exchange differences shall be recognized as income or expense in the period in which they arise.

<u>Option II</u> - Long Term Foreign Currency Monetary Items

Exchange differences arising on reporting of long-term foreign currency monetary items at rates different from those at which they were initially recorded during the period, or reported in previous financial statements,

- ***If they relate to the acquisition of a depreciable capital asset,***
  - ***can be added to or deducted from the cost of the asset and shall be depreciated over the balance life of the asset, and***
- ***in other cases,***
  - ***can be accumulated in the Foreign Currency Monetary Item Translation Difference (FCMITD) Account and should be written off over the useful life of the assets (amortized over the balance period of such long term assets or liability, by recognition as income or expense in each of such periods)***

The treatment availed at the option of the company shall be irrevocable and shall

be exercised till 31st March, 2020. In other words, if an entity chooses to capitalize exchange differences, it should continue the same policy till 31st March 2020.

An asset or liability shall be designated as a long-term foreign currency monetary item, if the asset or liability is expressed in a foreign currency and has a term of 12 months or more at the date of origination of the asset or liability.

4.0 : Financial Statement of Foreign Operations:

1. **Integral:** A foreign operation is said to be integral operations as if were an extended arm of the reporting entity. Any change in the foreign exchange rate will have all immediate impact on the cash flows of the reporting entity. Such an impact will arise from and will be relatable to all monetary items - except of course, the net investment of reporting entity.

   Example - A foreign operation might only sell goods imported from the reporting entity and remits back the proceeds to the reporting entity. Certain other situations that would be an integral operation are:

   - Acts as a selling agency: receiving stocks of goods from and remitting proceeds back to the investing company.
   - Produces a raw material or component, and transfers the goods for inclusion in the ultimate product being manufactured by investing company (end-products of foreign operations are captivity consumed by reporting entity)
   - Foreign operation has been set up to raise finance to help investing entity or for tax reasons.

2. **Non-integral:** An operation which is not an integral operation is called Non-Integral operation. A non-integral foreign operation accumulates cash and other monetary items, incurs expenses, generates income and perhaps arranges borrowings, all substantially in the local currency. It may also enter into transactions in foreign currencies, including transactions in the reporting currency".

   A question to be asked is -

   Will such operations have an impact on the cash flows from operations of reporting entity?

If answer is negative it is non-integral operations.

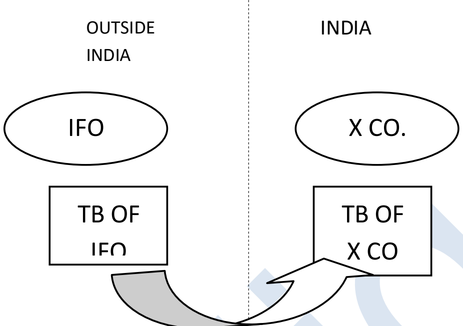
An analysis will show that in cases of the nature cited above, a change in the exchange rate between reporting currency, and the currency in which foreign operations are conducted — will not have any direct effect on the cash flows for reporting entity. The effect, if any, would be traceable to a change in the 'net investment in foreign operations" of reporting entity.

The focus is on whether there are any regular movement of cash or cash equivalents, or whether it is only occasional, i.e. remittance of dividends. Mere "control" is not a determinant factor. Impact on cash flows from operations is relevant.

SUMMARY OF ACCOUNTING FOR INTEGRAL AND NON INTEGRAL FOREIGN OPERATIONS

INTEGRAL FOREIGN OPERATIONS – (IFO)

Accounting treatment of integral Foreign Operations: The financial statements of an integral foreign operation should be translated using the principles and procedures in paragraphs 8 to16 as if the transactions of the foreign operation had been those of the reporting enterprise itself.



Convert the TB of IFO by using following rates:

ITEM	CONVERSION RATE
Fixed assets (including depreciation)	rate on date of acquisition
All monetary items	at closing rate
All incomes/ expenses (other than depreciation)	Actual rate Or Average rate if fluctuation is not high
HO Account	Actual amount as per books

NOTE - After conversion of TB of IFO from Foreign Currency to domestic currency, it may/ may not tally, as different exchange rates are used.
Such difference is foreign currency fluctuation on account of integral foreign operations and is charged off to P&L

NON INTEGRAL FOREIGN OPERATIONS – (NIFO)

ITEM	CONVERSION RATE
All Balance Sheet items	At closing rate
All Revenue items	Rate on date of transaction
Any goodwill/ Cap reserve/ Contingent liability	Closing rate

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

a. translating income and expense items at the exchange rates at the dates of transactions and assets and liabilities at the closing rate;

b. translating the opening net investment in the non-integral foreign operation at an exchange rate different from that at which it was previously reported; and

c. other changes to equity in the non-integral foreign operation.

The exchange fluctuations on account of conversion should be transferred to Foreign Currency Translation Reserve A/c (FCTR). FCTR cant be used for dividend distribution purpose. The same will be transferred to P&L when the NIFO is disposed off or discontinued.

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

OTHER KEY ASPECTS IN ACCOUNTING FOR NIFO -

1. **Consolidation** as per AS 21, 23, 27:

The incorporation of the financial statements of a non-integral foreign operation in those of the reporting enterprise follows normal consolidation procedures, such as the elimination of intra-group balances and intra-group transactions of a subsidiary (see AS 21, Consolidated Financial Statements, and AS 27, Financial Reporting of interests in Joint Ventures). However, an exchange difference arising on an intra-group monetary item, whether short-term or long-term, cannot be eliminated against a corresponding amount arising on other intra-group balances because the monetary item represents a commitment to convert one currency into another and exposes the reporting enterprise to a gain or loss through currency fluctuations. Accordingly, in the consolidated financial statements of the reporting enterprise, such an exchange difference continues to be recognized as income or an expense or, if it arises from the circumstances described in paragraph 15, it is accumulated in a foreign currency translation reserve until the disposal of the net investment.

2. **DIFFERENT REPORTING DATES**

When the financial statements of a non-integral foreign operation are drawn up to a different reporting date from that of the reporting enterprise, the non-integral foreign operation often prepares, for purposes of incorporation in the financial statements of the reporting enterprise, statements as at the same date as the reporting enterprise. When it is impracticable to do this, AS 21, Consolidated Financial Statements, allows the use of financial statements drawn up to a different reporting date provided that the difference is no greater than six months and adjustments are made for the effects of any significant transactions or other events that occur between the different reporting dates. In such a case, the assets and liabilities of the non-integral foreign operation are translated at the exchange rate at the balance sheet date of the non-integral foreign operation and adjustments are made when appropriate for significant movements in exchange rates up to the balance sheet date of the reporting enterprises in accordance with AS 21. The same approach is used in applying the equity method to associates and in applying proportionate consolidation to joint ventures in accordance with AS 23, Accounting for Investments in Associates in Consolidated Financial Statements and AS 27, Financial Reporting of Interests in Joint Ventures.

3. **CLASSIFICATION AND RECLASSIFICATION**

The classification of a Foreign Operation as IFO / NIFO is the responsibility of the management.

The accounting treatment to be followed on reclassification from IFO to NIFO and NIFO to IFO is summarised below:

IFO to NIFO

- Till the date of reclassification, exchange differences are transferred to P&L
- The exchange differences subsequent to date of reclassification are accumulated in Foreign Currency Translation Reserve (FCTR)

NIFO to IFO

- The accumulated balance in FCTR will be carried in the Balance Sheet. The balance will be transferred to P&L when the foreign operation is disposed.
- The exchange differences subsequent to date of reclassification is transferred to P&L.
- The translated amount of non-monetary items as on the date of change is treated as historical cost.

4. **DISPOSAL OF NIFO**

On the disposal of a non-integral foreign operation, the cumulative amount of the exchange differences which have been deferred and which relate to that operation should be recognized as income or as expenses in the same period in which the gain or loss on disposal is recognized.

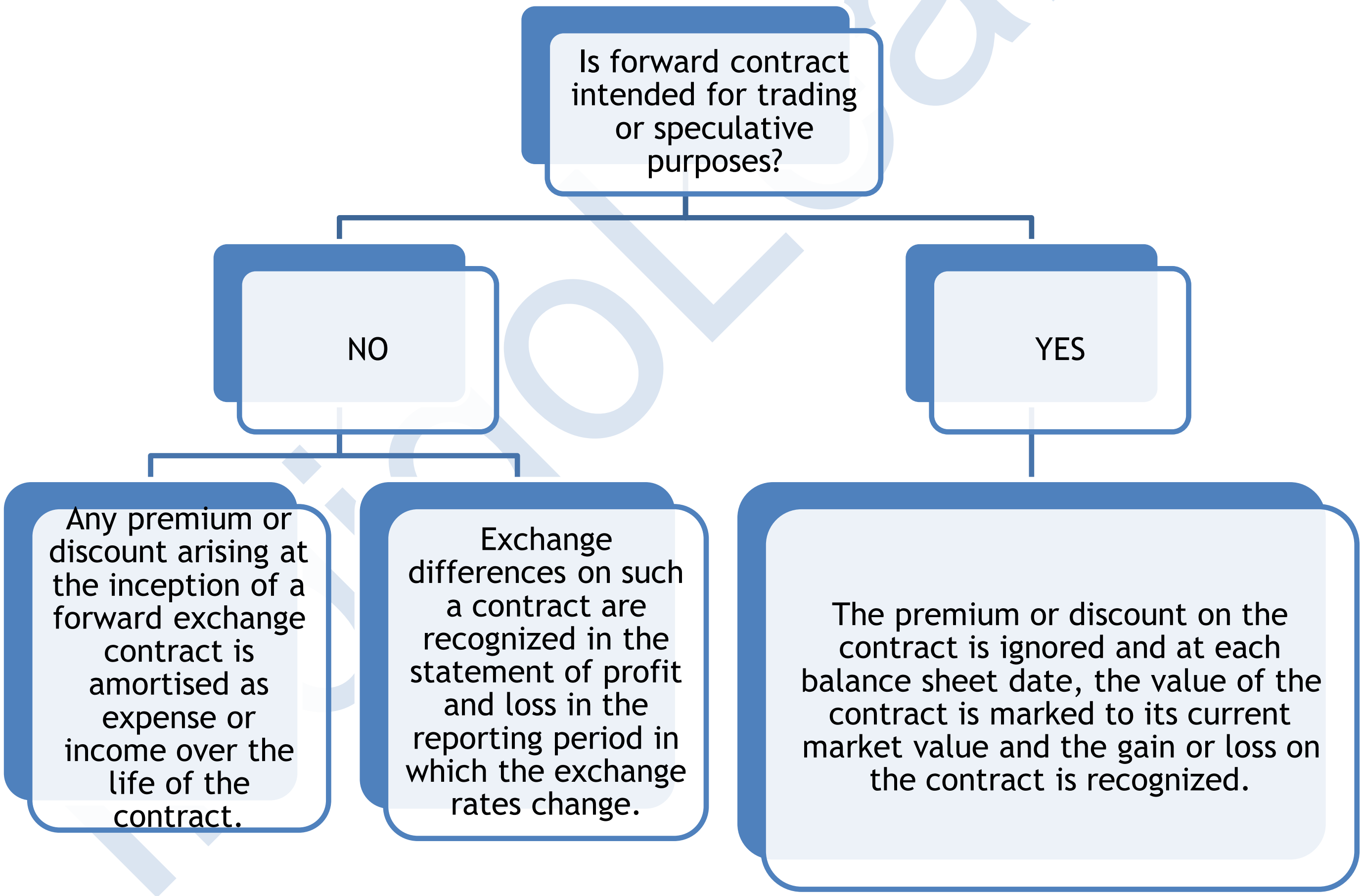
5. **FORWARD EXCHANGE CONTRACTS**

Category I: An enterprise may enter into a forward exchange contract or another financial instrument that is in substance a forward exchange contract, which is not intended for trading or speculation purposes, to establish the amount of the reporting currency required or available at the settlement date or a transaction.

The premium or discount arising at the inception of such a forward exchange contract should be amortized as expense or income over the life of the contract. Exchange differences on such a contract should be recognized in the statement of profit and loss in the reporting period in which the exchange rates change. Any profit of loss arising on cancellation or renewal of such a forward exchange contract should be recognized as income or as expense for the period.

Category II: In respect of a forward contract entered into as a speculative activity, Accounting Standard prescribes that the contract should he recognized on the reporting date. A gain or loss on a such forward exchange contract should be computed by multiplying the foreign currency amount of the forward exchange contract by the difference between the forward rate available at the reporting date for the remaining maturity of the contract and the contracted forward rate (or the forward rate last used to measure a gain or loss on that contract for an earlier period).

The gain or loss- so computed should be recognized in the statement of profit and loss for the period. The premium or discount on the forward exchange contract is not recognized separately.



5.0 : Disclosure requirements: An enterprise should disclose:

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

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

When the reporting currency is different from the currency of the country in which the enterprise is domiciled, the reason for using a different currency should be disclosed. The reason for any change in the reporting currency should also be disclosed.

When there is a change in the classification of a significant foreign operation, an enterprise should disclose:

a. the nature of the change in classification;

b. the reason for the change;

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

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

Matters to be disclosed	**Place of disclosure**
Amount of exchange differences included in the net profit or loss for the period.	Profit & Loss
Net exchange differences accumulated in foreign currency translation reserve as a separate component of shareholders funds and a recognisation of such exchange differences at the beginning and end of the period.	Balance sheet notes
Reason for using a different currency, when the reporting currency is different from the currency of the country in which the enterprises is domiciled.	Notes
Reason for any change, if any, in the reporting currency.	Notes
When there is a change in the classification of a significant foreign operation, (a) - the nature of the change in classification, (b) - the reason for the change (c) - the impact of the change in classification on presented had the change in classification occurred at the beginning of the earliest period presented.	Notes
Effect on foreign currency monetary items or on the financial statements of a foreign operation of a change in exchange rates occurring after the balance sheet date, as per AS – 4.	Notes
Enterprise's foreign currency risk management policy (optional disclosure).	Notes

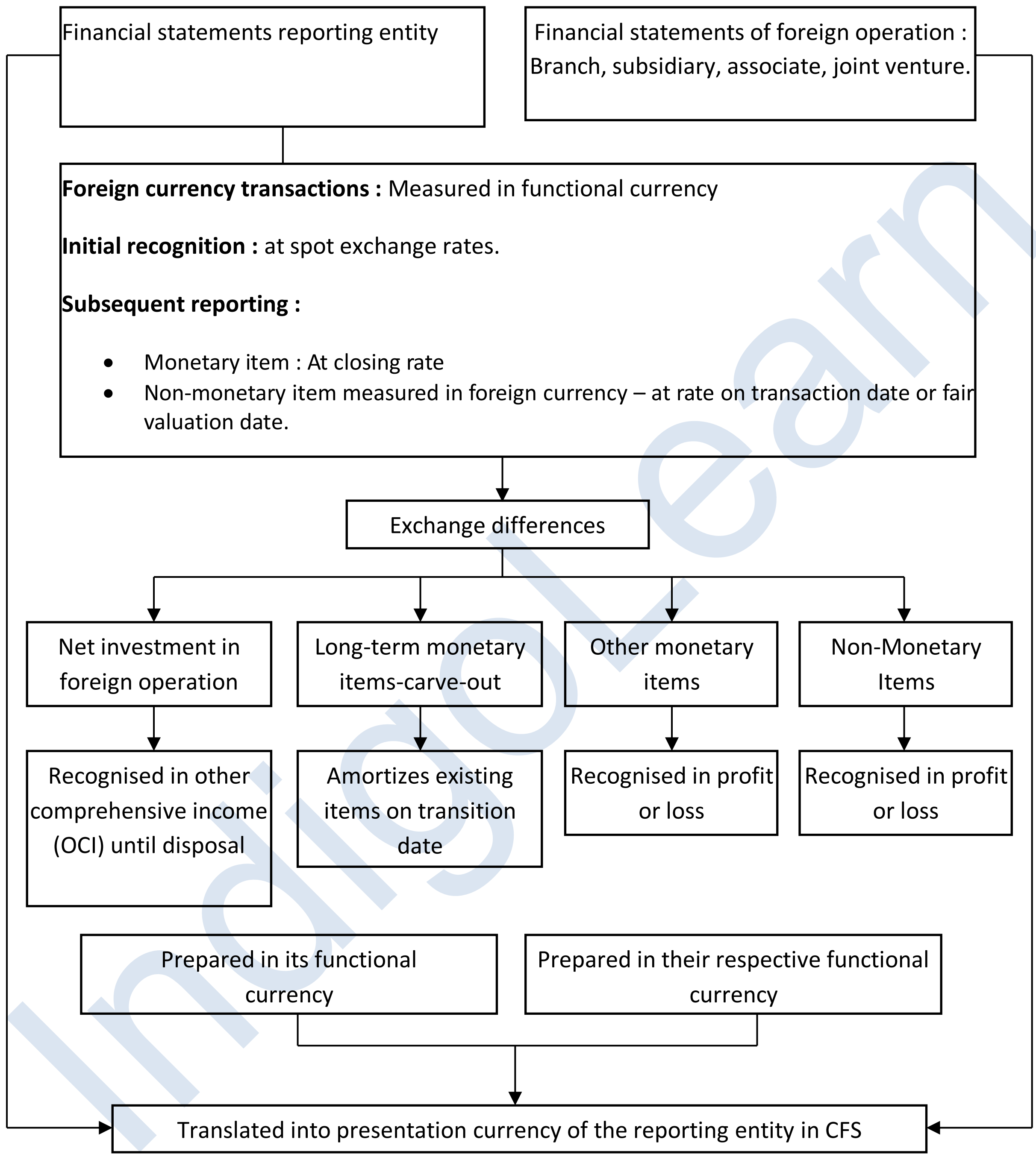
PRESENTATION OF FOREIGN CURRENCY MONETARY ITEM TRANSLATION DIFFERENCE ACCOUNT In the format of Schedule III to the Companies Act, 2013, no line item has been specified for the presentation of FCMITDA. Since the balance in FCMITDA represents the foreign currency translation loss, it does not meet the above definition of asset, as it is neither a resource nor any future economic benefit would flow to the entity there from. Therefore, such balance cannot be reflected as an asset. Therefore, Dr/ Cr balance in FCMITDA should be shown on the EQUITY and LIABILITIES side of the balance sheet under the head RESERVES AND SURPLUS as a separate line item

6.0: Expert Advisory Committee (EAC) Opinions on AS – 11

Date of transaction for translation purposes: The date of transaction in accounting is that date on which a transaction becomes eligible to be recognized in the books of accountant of the enterprise as per the relevant normally accepted accounting principles	**Vol XVI Pg,75**
Effect on Creditors' payment: • Balance of liability relating to impart of raw materials should be reported using the Closing Rate. Any Profit or Loss on conversion of said liability at Closing Rate should be recognized in the P & l Account for the reporting period. • When the liability is finally settled, the difference between book value of liability and value at which it is finally settled should be recognized in the P & L A/c of that period.	**Vol XIII Pg.7**
Capital payment from RBI approved account: A Bank account was opened in a foreign country with RBI approval, for Capital Payments only. Any gain/ loss arising on translation of the account should be disclosed in the Statement of Incidental Expenditure during Construction period (prepared in lieu of P & L Account) and capitalized.	**Vol XVII Pg.7**
The exchange difference arising on restatement of advance at the closing rate cannot be, adjusted in the cost of the Fixed Asset and should be expensed in the year in which it relates	
Foreign Construction Contracts: The translation rates for Financial Statements of foreign projects are – **1.** Revenue Items except inventories and depreciation – At Average Rate.	**XIV Pg.12**

2. Depreciation – At rates used for translation of the relevant Fixed Asset. **3.** Fixed Assets – At the rates prevailing on the date of purchase. **4.** Inventories – At the respective Balance Sheet dates, i.e. Opening and Closing Rates. **5.** Monetary Assets – At the Closing Rate. **6.** Other non-monetary assets – At the rates prevailing at the date of the relevant transaction **7.** Remittances from abroad and purchases of foreign currency in India – At the actual transaction rates.,” • The net difference from the translation of the above items should be recognized as Income / Expense. Provision for project performance, made in the Head Office books, should be calculated as a percentage of Turnover as translated in Indian Rupees. No exchange difference shall be recognized here. Actual expenditure on performance guarantee should be	
Companies should follow accrual basis and not cash basis of accounting to account for income from foreign consultancy jobs unless the income is not considered material.	**Oct 2008- CA Journal Page 627**

SUMMARY



Financial statements reporting entity
Financial statements of foreign operation : Branch, subsidiary, associate, joint venture.
Foreign currency transactions : Measured in functional currency
Initial recognition : at spot exchange rates.
Subsequent reporting :
Monetary item : At closing rate
Non-monetary item measured in foreign currency – at rate on transaction date or fair valuation date.
Exchange differences
Net investment in foreign operation
Long-term monetary items-carve-out
Other monetary items
Non-Monetary Items
Recognised in other comprehensive income (OCI) until disposal
Amortizes existing items on transition date
Recognised in profit or loss
Recognised in profit or loss
Prepared in its functional currency
Prepared in their respective functional currency
Translated into presentation currency of the reporting entity in CFS

Illustrations

Illustration1:

Explain Monetary Item as per AS 11. How are Foreign Currency Monetary items to be recognized at each balance sheet date?

Classify the following as monetary or non-monetary items.

Share Capital, Trade Receivables, Investments, Fixed Assets

Solution1:

Monetary Items are money held and Assets & Liabilities to be received or paid in fixed or determinable amounts of money. Eg: Debtors, Creditors, Loans etc.

Foreign Currency monetary items are recognized at closing rate at each balance sheet date.

- Share Capital - Non Monetary Item
- Trade Receivables - Monetary Item
- Investments - Non Monetary Item
- Fixed Assets - Non Monetary Item

Illustration 2:

BK Limited purchased fixed asset costing Rs. 5,000 lacs on 1.4.2012 payable in foreign currency (USD) on 5.4.2013. Exchange rate of 1 USD is Rs.50 and Rs.54.98 as on 1.4.2012 and 31.3.2013 respectively. The Company also obtained a soft loan of USD 100,000 on 1.4.12 payable in 3 equal annual installments. First installment was due on 1.5.13. You are required to state how these transactions are to be accounted for in the books of accounts for the year ended 31.3.13

Solution2:

Part 1

Date of acquisition of Fixed Asset 1.4.2012

Cost of acquisition: Rs.5000 lacs = USD 100 lacs X Rs. 50/USD

Creditor Reinstatement Date: 31.03.2013; Exchange rate 1 USD = Rs.54.98

Rupee Depreciation over the year 2012-13: Rs.4.98 per USD

Increase in creditor payables consequent to reinstatement following rupee depreciation:

Rs.4.98 /USD x USD 100 lacs = Rs.498 Lacs

Option 1: Rs.498 lacs of forex fluctuation can be debited to P&L in FY13

Option 2: The Company may also choose to capitalize this loss to the cost of the fixed asset so acquired.

Part 2:

Assume USD 100,000 of loan was used to acquire a Fixed asset / a non-monetary item

Loss on the reinstatement of the loan for FY2013 is

USD 100,000 x Rs.4.98 / USD = Rs. 4.98 lacs

Option 1: The loss may be entire charged off to P&L

Option 2:

a) If the asset so acquired from the loan is a fixed asset then the loss can be transferred to the fixed asset account.

b) If the asset so acquired is not a depreciable fixed asset or is for working capital purposes, the loss can be transferred to Foreign Currency Monetary Item Translation Difference Account (FCMITD) and written off in 3 years starting FY13. That will be well before 31.03.2020, the date before which all FCMITDA balances are to be written off as mandated by AS11.

Illustration 3:

Sterling Ltd. purchased a plant for US $ 20,000 on 31st December, 2011 payable after 4 months. The company entered into a forward contract for 4 months @ Rs. 48.85 per dollar. On 31st December, 2011, the exchange rate was Rs. 47.50 per dollar.

How will you recognize the profit or loss on forward contract in the books of Sterling Limited for the year ended 31st March, 2012?

Solution3:

Forward premium Paid by the Company per USD = Rs.48.85 - 47.50 = Rs1.35

The forward premium of Rs.1.35 is for a period of 4 months

Total forward premium = Rs. 1.35 X 20,000 = Rs. 27,000

Amount to be amortised per month = Rs 27,000/4 = Rs. 6750

Amount to be amortised for year ending 31.03.2012 = Rs. 6,750 X 3 months = Rs. 20,250

Rs.20,250 will be recognized in the books of sterling limited as forward premium expense for year ended 31st March 2012.

Illustration 4:

Goods purchased on 1.1.11 of USD 10,000 when USD 1 - Rs.45. Exchange rate on 31.3.11 is Rs.44 and exchange rate on date of actual payment (07.07.11) was Rs.43 . Ascertain the gain or loss for FY10-11 and FY11-12. Also give treatment as per AS 11.

Solution 4:

Technical context:

As per AS 11, Monetary items have to be restated at the end of an accounting period at the closing rate prevailing on such date

Analysis & Conclusion

Part 1

Liability towards Creditors for Cost of goods purchased on 1.1.11 – Rs.45 X 10,000 = Rs.4,50,000

On 31.3.11 such creditor balance (monetary item) needs to be reinstated at closing rate. Closing rate on 31.3.11 is Rs.44 / USD

Rupee appreciated from Rs.45/ USD to Rs.44 USD – there is gain of Re 1.

For FY11 gain of Rs.10,000 (USD 10,000 x Re.1/ USD of gain) will be recognized in P&L

Part 2

Rupee appreciated by additional Re.1 between 31.3.11 and 7.7.11 and the payment was made at Rs.43/ USD on 7.7.11

Additional gain of Rs.10,000 (USD 10,000 x Re.1/ USD of gain) will be recognized in P&L in FY12

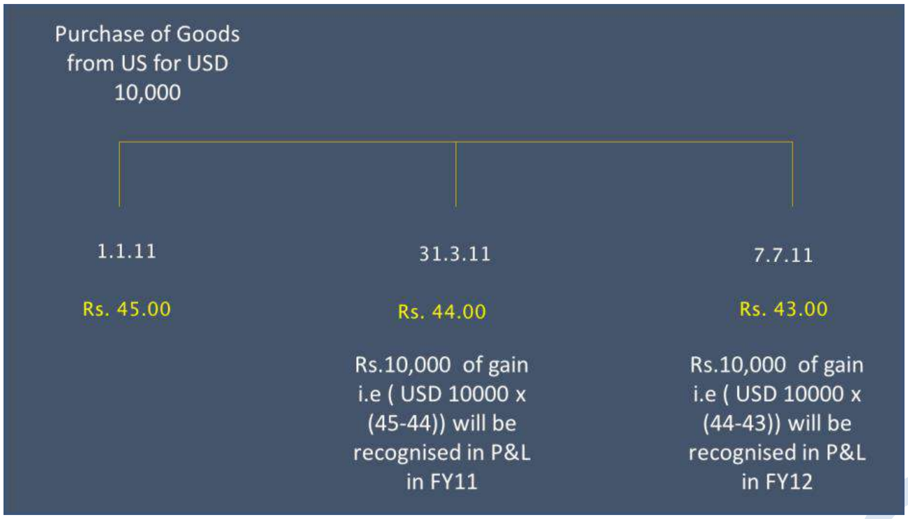


Illustration 5:

Sunshine Company Limited imported raw materials worth US Dollars 9,000 on 25th February, 2011, when the exchange rate was Rs. 44 per US Dollar. The transaction was recorded in the books at the above mentioned rate. The payment for the transaction was made on 10th April, 2011, when the exchange rate was Rs. 48 per US Dollar. At the year end 31st March, 2011, the rate of exchange was Rs. 49 per US Dollar.

The Chief Accountant of the company passed an entry on 31st March, 2011 adjusting the cost of raw material consumed for the difference between Rs. 48 and Rs. 44 per US Dollar. Discuss whether this treatment is justified as per the provisions of AS-11.

Solution 5:

Technical context:

As per AS 11, Monetary items have to be restated at the end of an accounting period at the closing rate prevailing on such date

Analysis:

In the current case, creditor in respect of raw materials is a monetary item and has to be restated at the closing rate on 31.3.11 in the books of Sunshine Limited. The creditor has to be reinstated on 31.3.11 at the exchange rate prevailing on 31.3.11 i.e. at Rs. 49 per USD

Exchange loss of Rs.45,000 i.e USD 9000 x (Rs.49 –Rs.44 = Rs.5) is recognized in FY11.

There is an exchange gain from the balance sheet date (31.03.2011) to the date of actual payment. Exchange gain of Rs.9000 i.e USD 9000 x (Rs.49/ USD –Rs.48/ USD = Rs.1/USD) is recognized in FY12.

Conclusion

The amount payable to creditor (which is a monetary item) must be reinstated. Any loss or gain arising due to such reinstatement must be transferred to profit and loss account as "Foreign Exchange Fluctuation Gain/(Loss). Treatment of recognizing exchange gain of Rs.36000 by reducing the cost of raw material in FY11 as proposed by the chief accountant is is not justified

Illustration 6:

Explain briefly the accounting treatment needed in the following cases as per AS 11 as on 31.3.15:

1. **Sundry debtors include amount receivable from Umesh Rs.5 lacs recorded at the prevailing Exchange rate on the date of sale. Transaction recorded at USD 1 = Rs. 58.50**
2. **Long term loan taken from a US company amounting to Rs.60 lacs recorded at USD 1 = 55.6; exchange rate taken at rate prevailing on date of transaction.**

On 31st March 2015 USD 1 = Rs.61.20

Solution 6:

Sundry Debtors: Amount receivable from Umesh in USD = Rs. 5,00,000 / (Rs.58.5 per USD) = USD 8547

Accounting as on 31.3.15:

Rupee depreciation from date of transaction to 31.3.15 :

Rs. 61.20 / USD– Rs. 58.5/ USD = Rs. 2.70/ USD of gain

Total gain on monetary item i.e receivable from Umesh = USD 8547 x Rs.2.70 / USD = Rs.23,077

This gain will be recognized in P&L with corresponding increase in the receivable account.

Treatment of long term loan:

Loan in USD = Rs.60 lacs / Rs.55.60 per USD = USD 107913.67

For a monetary payable, rupee depreciation will result in a loss.

Loss is Rs.61.20/ USD – Rs.55.60 / USD = Rs.5.60/ USD

Total loss = Rs.5.60 / USD x USD 107913.67 = Rs.604317

This loss on long term loan can be

1) transferred to P&L or
2) If it is for a depreciable asset capitalised it along with the cost of the fixed asset, If not it can be accumulated in FCMITD account and written off

Illustration 7

AXE Limited purchased fixed assets costing $ 5,00,000 on 1st Jan. 2018 from an American company M/s M&M Limited. The amount was payable after 6 months. The company entered into a forward contract on 1st January 2018 for five months @ Rs. 62.50 per dollar.

The exchange rate per dollar was as follows :

On 1st January, 2018 Rs. 60.75 per dollar

On 31st March, 2018 Rs. 63.00 per dollar

You are required to state how the profit or loss on forward contract would be recognized in the books of AXE Limited for the year ending 2017-18, as per the provisions of AS 11

AS-12

WHY IS THIS STANDARD REQUIRED?

The receipt of Government assistance by an entity may be significant for the preparation of financial statements for two reasons. Firstly, if resources have been transferred, an appropriate method of accounting for transfer must be found. Secondly, it is desirable to give an indication of the extent to which the entity has benefitted from such assistance during the reporting period.

AS-12 Accounting for Government Grants
Scope: AS – 12 deals with this important topic of grants or assistance in the from both capital and revenue, from various government agencies. These grants are also referred to as subsidies, cash incentives, duty drawbacks etc. These can also be non-monetary, e.g. land or other resources, the standard provides accounting method that can be followed, to suit specific situations. The standard does not deal with

1. Accounting for grants, in FS that reflect the effect of changing price
2. Other indirect forms of assistance, or
3. Government participation in the ownership of enterprises.

Definitions:

Government Grants - Defined: Government grants are assistance by Government in cash or kind to an enterprise for past or future compliance with certain conditions. They exclude those forms of government assistance which cannot reasonably have a value placed upon them and transactions with government which cannot be distinguished from the normal trading transactions of the enterprise.

Illustration 1: Company A deals in a product which attracts 5% Sales Tax. However, under some package scheme of incentive, the Company is exempt from Sales Tax upto a certain limit. Is this a Govt. Grant?

Answer – NO. As, Government grant is "Assistance by government in cash or in kind"

Government refers to state and Central Government, Government agencies and similar bodies, whether local, national or international.

Recognition of Government Grants

Government grants should be recognized only if there is a certainty that

(i) the enterprise will comply with the conditions attached to them; and

(ii) the grants will be received

Government grant may be awarded for the purpose of giving immediate financial support to an enterprise rather than as incentive to undertake specific expenditure. In this case, the grant may be taken to income in the period in which the enterprise qualifies to receive it, as an extraordinary item.

Method Of Accounting:

AS 12 lays down two possible methods for accounting treatments of government grants, viz:

a)Capital Approach: In capital approach, grant is treated as part of shareholders' funds.

b)Income Approach: In income approach, a grant is treated as income (of one or more periods depending upon circumstances of each case).

In other words, government grants are recognised in the profit and loss statement on a systematic and rational basis over the periods necessary to match them with the related costs.

Government grants should not be recognised on a receipt basis. If these are recognised on a receipt basis then that will not be in accordance with the fundamental accounting assumption of 'Accrual' as envisaged in AS 1 on 'Disclosure of Accounting Policies.'

Which method should be adopted:

Accounting for government grants should be based on the nature of the grants. Grants which have the characteristics similar to those of promoters' contribution (i.e, which are given with reference to the total investment in an undertaking or by way of contribution towards its total capital outlay and no repayment is ordinarily expected) should be accounted for on the basis of 'Capital Approach', whereas other grants (ie, grants related to revenue) should be accounted for on the basis of 'Income Approach'.

Following paragraphs explain Accounting Treatment of Government Grants:

A. Accounting Treatment of Grants in the nature of capital receipts (Capital Approach):

1. Grant received is not for acquiring specific fixed asset. (i.e. in the nature of promoter‘s contribution):

Government grants can be in the nature of promoter‘s contribution, examples include a capital subsidy for a project. Such grants should be ***credited to capital reserve*** and treated as part of shareholders’ fund, in as much as no repayment is ordinarily expected in respect of such grants.

Entry required:

Cash/ Bank Account…………………………….Dr.

To Capital Reserve A/c.

2. Grant received for acquiring specific fixed assets:

Grants related to specific fixed assets are government grants whose primary condition is that an enterprise qualifying for them should purchase, construct or otherwise acquire such assets. Other conditions may also be attached restricting the type or location of the assets or the periods during which they are to be acquired or held.

The grants relating to specific fixed assets could relate to depreciable as well as non-depreciable fixed assets. We shall now discuss the treatment of grants in each of these cases:

Option – 1 : Deduct the value of grant from the cost of Fixed Asset

- Deduct grant from gross value of asset.
- Depreciate the asset on net value (ie, gross value less the amount of grant).
- If grant equals the whole or virtually the whole of the cost of the asset then the asset should be recorded at a nominal value.

Entries required:

1. Cash/ Bank Account…………………….Dr.

    To Government Grant A/c

2. Fixed Asset Account……………………Dr.

    To Cash/Bank A/c.

3. Government Grant A/c …………………Dr.

    To Fixed asset account

(Note: depreciation is charged on the adjusted balance of fixed asset.)

- **Example**

Gross value of asset	Rs.1 crore
Government grant	
(i)	Rs.20 lakhs
(ii)	Rs. 1 crore

In situation (i), the asset will be recorded at Rs 80 lakhs in the balance sheet and depreciation will also be charged on this amount of Rs 80 lakhs.

In situation (ii), the asset should be recorded at a nominal value, say, Rs 100, in the balance sheet, so that the existence of the asset, is reflected. No depreciation is to be charged in this case.

Option – 2:

Situation1: Fixed Asset is non-depreciable asset.

The grant is credited to capital reserve, However, if the grant requires the fulfillment of certain obligations then the grant should be credited to income over the same period over which the cost of meeting such obligations is charged to income and the deferred income balance should be separately disclosed in the financial statements.

Entry required:

Cash/Bank Account……………………… Dr.

To Capital reserve A/c

Situation 2: Fixed Asset is depreciable asset - Grant is treated as a deferred income

- Treat the grant as deferred income and recognise it in the profit and loss account in the proportions in which depreciation on such asset is charged.
- Depreciate the asset on the basis of its gross value.

Entries required:

1. Cash/Bank Account……………………...Dr.

To Government Grant A/c

2. Fixed Asset Account……………………..Dr.

To Cash/Bank A/c

3. Depreciation A/c…………………………Dr. Entry No 3 & 4 are passed each year

To fixed Asset A/c. during the useful life of the asset

4. Government Grant A/c…………………..Dr

To P& L Account

- **Example**

In the example that has been discussed, if it is desired that Option 2 is followed, then in both the situations, the asset will be recorded at the full value of Rs 1 crore in the balance sheet.

In the first situation, every year an amount of Rs 2 lakhs (assuming useful life is 10 years and straight line method of depreciation is followed) and in the next case, an amount of Rs 10 lakhs will be credited to the profit and loss account for a period of 10 years.

B. Grant in the nature of revenue receipts (Revenue Approach)

Government grant related to revenue should be recognized on a systematic basis in the profit and loss statement. Such recognition should be spread over the periods necessary to match them with the related costs, which the grant is intended to compensate.

Hence, two alternatives are possible:

Alternative I

Credit the grant to the profit and loss account, either separately or as a part of 'other income'.

Alternative II

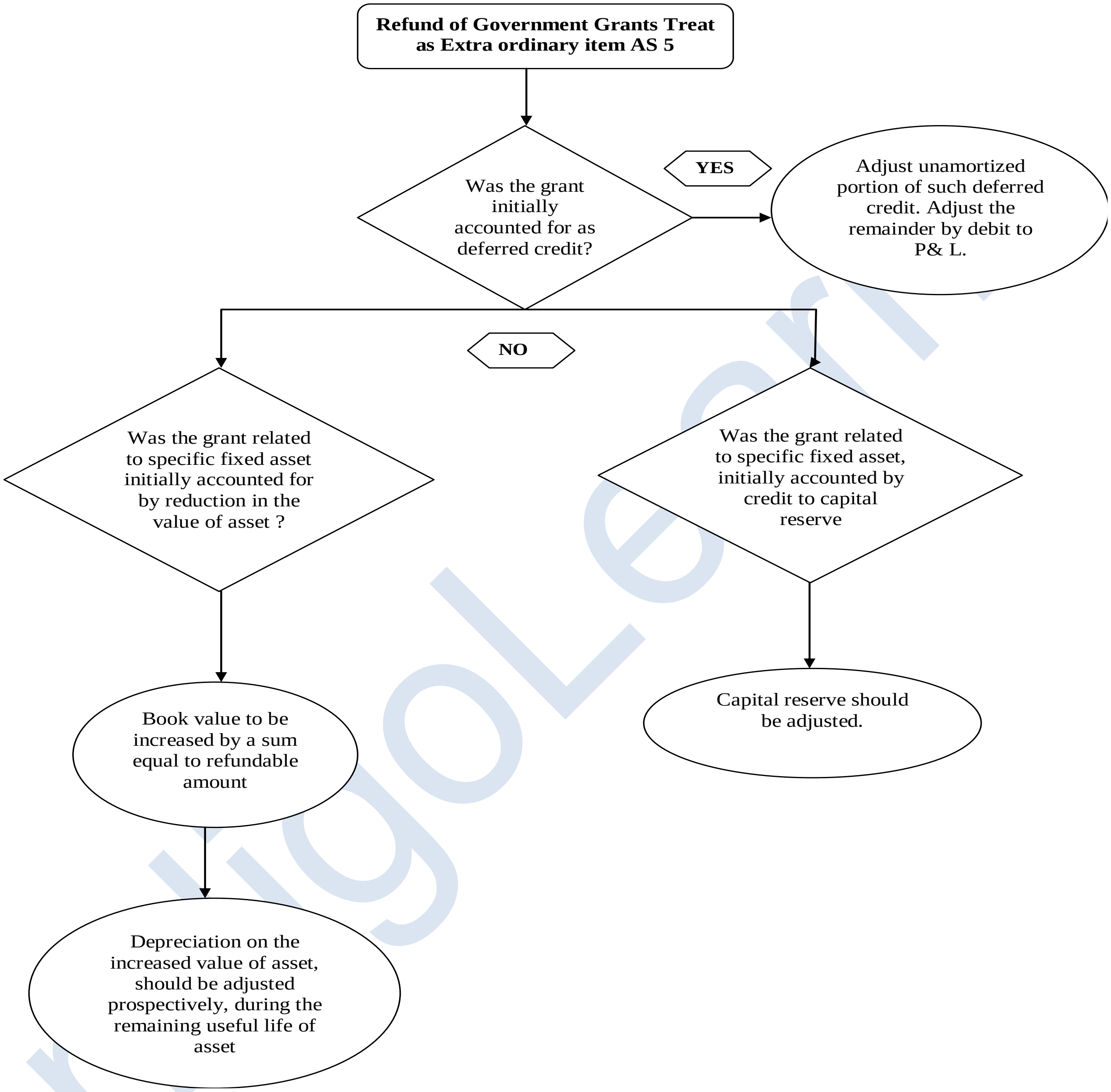
Deduct the grant so received from the related expenses (which they intend to compensate).

Refund of Government Grants.

A government grant may have to be refunded if certain conditions attached to it have not been fulfilled. In such a case, the following treatment should be adopted:

Government grants that become refundable should be accounted for as an extraordinary item.

Nature of Grant	***Treatment at the time of receipt of Grant***	***Treatment required at the time of refund***
Revenue	Credited to Profit & Loss	Debit to Profit & Loss
Revenue/Capital	Credited to Deferred Income	Debit to Deferred Income. *In case of insufficient balance in Deferred Income account, debit Profit & Loss*
Capital	Reduced from value of fixed asset	Increase the value of fixed asset. *Depreciation to be charged on revised asset value prospectively over the remaining useful life of asset.*
Capital	Credited to Capital Reserve	Debit to Capital Reserve


Refund of Government Grants Treat as Extra ordinary item AS 5
Was the grant initially accounted for as deferred credit?
YES
Adjust unamortized portion of such deferred credit. Adjust the remainder by debit to P& L.
NO
Was the grant related to specific fixed asset initially accounted for by reduction in the value of asset ?
Was the grant related to specific fixed asset, initially accounted by credit to capital reserve
Book value to be increased by a sum equal to refundable amount
Capital reserve should be adjusted.
Depreciation on the increased value of asset, should be adjusted prospectively, during the remaining useful life of asset

➢ **Example**

X Ltd. received a government grant for purchase of plant and machinery. The grant amount was Rs 10 lakhs and the gross value of plant and machinery was Rs 40 lakhs. The grant was received on 1-4-2005 and certain conditions regarding production were attached to it. The plant and machinery, having a useful life of 10 years, was acquired on the same date and put to use. In the year 2008-09, an amount of Rs 4 lakh became refundable as the desired level of production could not be achieved. Suggest how should this be recorded in the accounts assuming that the company follows straight line method of depreciation?

AS 12 provide several alternatives in which the refund of government grant be treated in accounts. These are as under:

1. An amount of Rs 4 lakhs could be reduced set off against the deferred income balance (in the present case which will be Rs 7 lakhs as the total grant of Rs 10 lakhs will be recognised over a period of 10 years).

2. Alternatively, the book value of the plant and machinery can be increased by Rs 4 lakhs and depreciation calculated accordingly. The relevant calculations are shown below:

	Rs.
Gross Book Value on 1-4-2005	40 lakhs
Net Book value on 1-4-2005	30 lakhs
Annual depreciation (assuming no scrap value)	3 lakhs
Book value on 1-4-2008 (Rs. 30 lakhs – Rs, 9 lakhs)	21 lakhs
Amount of grant refundable	4 lakhs
Revised book value	25 lakhs
Remaining useful life	7 years
Revised annual depreciation	

= Revised book value

Remaining useful life

= Rs. 2500000 / 7

= Rs. 3,57,143 (approx)

12.1. Disclosure Requirements: The following are the disclosure requirements of standard.

- The accounting policy adopted for government grants, including the methods of presentation in the financial statements;

- The nature and extent of government grants recognized in the financial statements, including grants of non-monetary assets given at a concessional rate or free of cost.

12.2. Some Noteworthy points:

1) Grant may be Non-Monetary

Case 1: Grant may be in the form of Assets acquired at concessional rate. e.g. Land allotted in industrial park at concessional rate. in such case it shall be recorded at its. acquisition cost

Case 2: Grant may be in the form of Assets, received free of cost. In such case it is recorded at a Nominal value (say Rs.100) for the purpose of identification and control.

Grant may be receivable by an enterprise as compensation for expenses or losses incurred in a previous accounting period. Such grant is recognized in Income statement of the period in which it becomes receivable, as extra- Ordinary items (if considered appropriate) as per AS-5

2) How should a contingency relating to government grants be treated

A contingency related to a government grant, arising after the grant has been recognised, should be treated in accordance with AS 4 on "Contingencies and Events Occurring after the Balance Sheet Date".

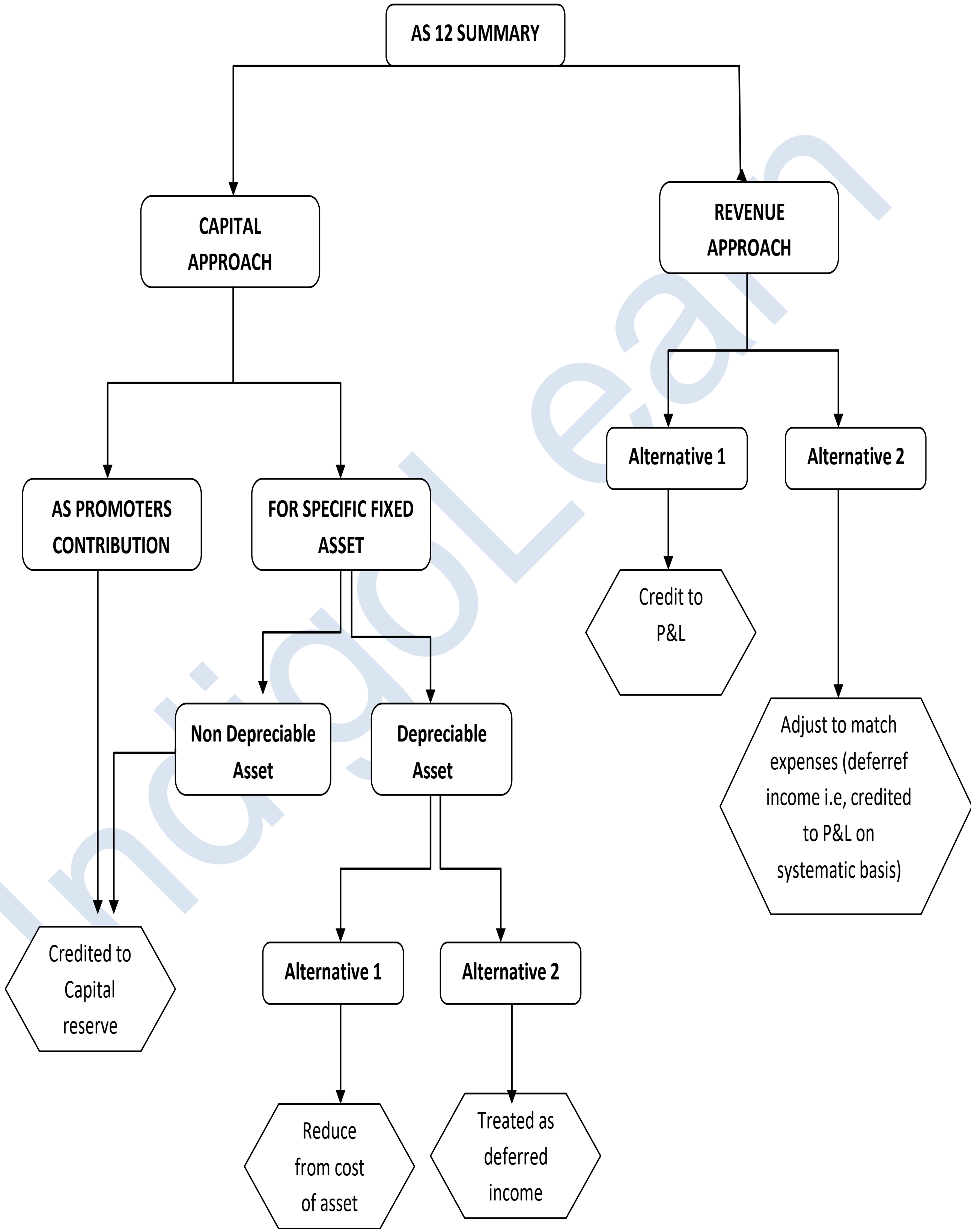
3) When can a government grant be treated as an extraordinary item

In the following circumstances a government grant may be treated as an extraordinary item:

a) when the grant is awarded for the purpose of giving immediate financial support to an enterprise rather than as an incentive to undertake specific expenditure;

b) when the grant is awarded as compensation for expenses or losses incurred in a previous accounting period.

In such a case, AS 5 on 'Net Profit or Loss for the period, prior period items and changes in accounting policies' should be followed.


AS 12 SUMMARY
CAPITAL APPROACH
REVENUE APPROACH
AS PROMOTERS CONTRIBUTION
FOR SPECIFIC FIXED ASSET
Alternative 1
Alternative 2
Credit to P&L
Adjust to match expenses (deferref income i.e, credited to P&L on systematic basis)
Non Depreciable Asset
Depreciable Asset
Credited to Capital reserve
Alternative 1
Alternative 2
Reduce from cost of asset
Treated as deferred income

SAMPLE DISCLOURES IN BALANCE SHEET

Government grants The Group recognizes government grants only when there is reasonable assurance that the conditions attached to them shall be complied with, and the grants will be received. Government grants related to depreciable assets are treated as deferred income and are recognized in the consolidated statement of profit and loss on a systematic and rational basis over the useful life of the asset. Government grants related to revenue are recognized on a systematic basis in the consolidated statement of profit and loss over the periods necessary to match them with the related costs which they are intended to compensate.

OTHER LONG TERM LIABILITIES

Particulars	**March 2015**	**March 2014** ***INR CRORES***
Deferred income - government grant on land use rights*	—	—

***** During the year ended March 31, 2014, XYZ Co received a grant of approximately `___ crore from Government towards construction of campus which is yet to be completed.

Illustrations

Illustration 1

Supriya Ltd. received a grant of Rs. 2,500 lakhs during the accounting year 2010-11 from

Government for welfare activities to be carried on by the company for its employees. The grant prescribed conditions for its utilization. However, during the year 2011-12, it was found that the conditions of grants were not complied with and the grant had to be refunded to the government in full.

Elucidate the correct accounting treatment, with reference to the provisions of AS-12.

Solution 1

The Government grant was received for carrying out welfare activities for its employees. The Grant received was of revenue in nature and hence would have been credited to profit and loss account at the time of receipt (or in proportion of expenses over the years in which expenses for employee welfare was incurred).

The amount refundable in respect of a government grant related to revenue is applied first
Against any unamortised deferred credit remaining in respect of the grant. To the extent that
the amount refundable exceeds any such deferred credit, or where no deferred credit exists,
The amount is charged immediately to profit and loss statement. In the present case, the amount of refund of government grant should be shown in the profit & loss account of the company as an extraordinary item during the year 2011-12

A government grant that becomes refundable is treated as an extraordinary item as per AS 5.

Illustration 2:

A Ltd. purchased a machinery for Rs. 40 lakhs. (Useful life 4 years and residual value

Rs. 8 lakhs). Government grant received is Rs. 16 lakhs.

Show the Journal Entry to be passed at the time of refund of grant and the value of the fixed assets, if:

i. the grant is credited to Fixed Assets A/c.

ii. The grant is credited to Deferred Grant A/c.

Solution 2:

i. **If the grant is credited to Fixed Asset Account,**

Fixed Asset A/c .... Dr. ... Rs. 16 lacs

To Cash/Bank Rs. 16 lacs

Original Cost	Rs. 40 lacs
Less: Grant Received	Rs. 16 lacs
Carrying Amount	Rs. 24 lacs
Less: Residual Value	Rs. 8 lacs
Depreciable Value	Rs. 16 lacs
Useful Life	4 years
Depreciation Per Year	Rs. 16 lacs/4 = Rs. 4 lacs
WDV at the end of Second Year	= Rs. 24 lacs – Rs. 4 lacs X 2 = Rs. 16 lacs
Add: Amount of Refund	Rs. 16 lacs
Value of Asset after Refund	= Rs. 32 lacs

ii. **If the grant was credited to Deferred Grant Account.**

Depreciation per year = Rs. (40 lacs – Rs. 8 lacs) /4 = Rs. 8 lacs per annum.

The grant will be credited to Profit and Loss Account equally (because depreciation is charged on SLM basis and hence ratio of depreciation is 1:1:1:1).

Amount credited to Profit & Loss Account for 2 years = Rs. 16 lacs/4 X 2 = Rs. 8 lacs.

Balance left in Deferred Grant Account after 2 years = Rs. 16 lacs – Rs. 8 lacs = Rs. 8 lacs.

The refund of grant in this case should be debited to Deferred Grant Account to the extent of balance available. Since the amount of refund is more than the balance in Deferred Grant Account, the shortfall will be debited to profit and loss account.

The journal entry will be:

Deferred Government Grant	Dr ...	Rs. 8 lacs	
Profit & Loss Account	Dr....	Rs. 8 lacs	
To Cash/Bank			Rs. 16 lacs

The refund of grant will not impact the fixed asset account.
Balance in fixed asset account at the time of refund = Rs. 40 lacs – Rs. 8 lacs X 2 = Rs. 24 lacs.

Illustration 3:

Santosh Ltd. has received a grant of Rs. 8 crores from the Government for setting up a factory in a backward area. Out of this grant, the company distributed Rs. 2 crores as dividend. Also, Santosh Ltd received land free of cost from State Government but it has not recorded it at all in its books as no money has been spent. In the light of AS 12 examine, whether the treatment of both the grants is correct.

Solution 3:

Grant received for setting up a factory is in the nature of promoter's contribution and should be credited to Capital Reserve. Such amount is not available for distribution as dividend. Hence, the company is not permitted to distribute dividend out of such grant. The accounting treatment given by the company is not in accordance with AS-12.

According to AS-12, if assets are received free of cost from Government as a grant, such assets should be recorded at nominal value. Hence, in the given case, the company must record the land received free of cost at a nominal value (say Rs. 1 or Rs. 10). The accounting treatment given by the company is not correct.

Illustration 4:

Viva Limited received a specific grant of Rs. 30 lacs for acquiring a plant of Rs. 150 lacs during 2007-08 having useful life of 10 years. The grant received was credited to deferred income in the balance sheet.

During 2010-11, due to non-compliance of conditions laid down for the grant, the company had to refund the whole grant to the government. Balance in the deferred income account on that date was Rs. 21 lacs and written down value of the plant was Rs. 105 lacs.

i. What should be the treatment of refund of grant and the effect on cost of the fixed asset and amount of depreciation charged during the year 2010-11 in profit and loss account?

ii. What should be the treatment of refund, if grant was deducted from the cost of plant during 2007-08 assuming plant account showed a balance of Rs. 84 lacs as on 1.4.2010?

Solution 4:

i. If the amount was initially recorded to deferred income initially, the amount of refund must be debited to the deferred account to the extent of balance available. Any shortfall in deferred income account should be debited to profit and loss account. The total amount of refund is Rs. 30 lacs and the balance available in deferred income account is only Rs. 21 lacs. The shortfall of Rs. 9 lacs must be debited to profit and loss account.

Deferred Income A/c Dr.... Rs. 21 lacs

Profit & Loss A/c Dr. Rs. 9 lacs
To Cash/Bank Rs. 30 lacs

ii. If the grant was deducted from cost of fixed asset account, the amount of refund must be debited to fixed asset account. The value of fixed asset account in this case would be increased by Rs. 21 lacs and the revised value of fixed asset would be depreciated over the balance useful life.

Fixed Asset A/c Dr. ... Rs. 30 lacs
To Cash/Bank Rs. 30 lacs

Balance in Fixed Asset account = Rs. 84 lacs + Rs. 30 lacs = Rs. 114 lacs.
Revised depreciation = Rs. 114/7 = Rs. 16.286 lacs per year.

Illustration 5

Samrat Limited has set up its business in a designated backward area which entitles the company for subsidy of 25% of the total investment from Government of India.

The company has invested Rs. 80 crores in the eligible investments. The company is eligible for the subsidy and has received Rs. 20 crores from the government in February 2019.

The company wants to recognize the said subsidy as its income to improve the bottom line of the company. Do you approve the action of the company in accordance with the Accounting Standard?

AS-13- Accounting for Investments

Status and Applicability: The AS —13 is mandatory in nature and is applicable to all enterprises with effect from 1.4.1995. Now AS 13 is applicable in the following two cases only.
1. In case of all commercial, industrial and business entities except SME, AS 13 is applicable only to the extent it relates to accounting for Investment in properties.
2. AS 13 is applicable to SME (Small and Medium Sized Entity) since AS 30, 31, 32 are not applicable to them. A SME is defined as under:
For the above purpose an entity is a small and Medium-sized Entity, if the conditions mentioned therein are satisfied as at end of the relevant accounting period.

Objective and Scope: Enterprises often hold investment for the sake of income by way of Interest and dividend. The AS — 13 deals with the accounting treatment and presentation in financial statements in respect of classification, cost, carrying amount, disposal and disclosure of investment

Definitions: The following terms have been used in the Standard as specified:

Investments are assets held by an enterprise for earning income by way of dividends, 'interest, capital appreciation, or for other benefits. Shares, debentures and other securities held sale in ordinary course of business are not. Investments i.e. assets held as stock-in-trade are not 'investments'.
A current investment is an investment which is readily realizable and is intended to be held for not more titan one year.
A long-term investment is an investment other than a current investment.

Fair value is the amount for which an asset could be exchange between a willing buyer and a seller in an arm's length transaction. Market value or net realizable value is usually taken as fair value.
Market value is the amount realizable from the sale of an investment in an open market.

Exclusions From AS-13: The standard does not deal with:

- Operating or finance leases (covered under AS —19)
- investments under retirement benefit plans (covered under AS — 15)
- Investments of mutual funds or banks (ICAI has issued separate guidance note covering mutual fund, while RBI regulations apply to banks).
- Shares, Debentures, Securities held as Stock-in-trade (Le. for sale in the ordinary course of business)

- Investment held by insurance Company (Insurance Regulatory and Development Act 1999)

Classification Linkage With Valuation: The valuation of an investment in the financial statement will depend on the intention behind holding such investments in the business,

Once the intention is identified, the asset can be correctly classified and valued as per the Standard.
For purposes of accounting, AS — 13 bring investments of an entity into two broad classifications

- based on "intention to hold or intention to sell", Accordingly, investments are to be classifies as
- Current Investment (which are intended to be held for NOT more than 12 months from the date of investments)
- Long Term investments (others)

Classification and Grouping: Current investments are not different from current assets. However, such investments are commonly included under "investments" and not current assets, Components of investments that constitute either current or long-term investments should he grouped as per Statue governing the enterprise. In the absence of statutory requirement, the Standard requires the following grouping:
Current or long term (depending on intention) investments in:

- Government or Trust securities
- Shares, debentures or bonds
- Others- Specifying nature.

Note: investment. in "properties" should always be classified as Long term, cost of shares in Co-operative society or a company may represent this investment.

Cost Of Investments: Similar to the principles underlying the determination of the cost of fixed assets (AS-10) cost of investment asset should comprise its .purchase price and any other costs directly attributable to the transaction. These are brokerage, fees and duties payable.
Subject to limitations prescribed under AS-16, finance and borrowing costs c311 be capitalized and included as an element of cost of an investment property.

Following are some noteworthy points in connection with cost of investments.

- investment acquired by issue of shares: For acquisition of an investment, consideration need not necessarily be paid in cash. it can be by Issue of shares — either for full value of consideration or for part or the value. Cost in such cases,. should be "fair- value" of securities issued (e.g.. issue price). Fair value does not mean either "par value" or 'nominal value' but can be even less or more than par.

  "Fair value is the amount for which an asset could be exchanged between a knowledgeable. Willing seller, in an arm's length transaction. Inappropriate cases, market value of net realizable value provides an evidence of fair value".

- Investment acquired in exchange for another: One investment can be exchanged for another.

The guiding principles for determining cost. in such cases are:
a) Fair Market Value of asset given up — is ideal, or

b) FMV of asset acquired where such MV is more clearly evident,

- Investment in Right shares: When right shares offered are subscribed for, cost of right shares is added to the carrying cost of the original holding. if rights are not subscribed for but are sold or renounced in The market, the sale proceeds. are taken to P & L.

  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 at which they were acquired. it will be. Appropriate to apply the sale proceeds of "right- to-subscribe" to reduce the carrying amount of such investments to the market value. (refer Problem.No_3)

- Earnings from investments: Interest anti dividends on investment are' to be treated as income in the normal course, However, when the purchase is made on cum-interest or cum-dividend terms, there is a need to allocate the interest or dividend received, to capital anti revenue as appropriate.

Carrying Amount Of investments (valuation): A member discharging attest functions has to verify critical areas. First is "existence" of investments. Second is "valuation". Determination of carrying amount of investment is, therefore, a very critical aspect. The prescriptions under AS-13 are summarized below.

Carrying amounts in, Financial Statement	
Current Investments	**Long Term investment**
1) select individual investment (more prudent approach) or select category wise (equity preference, etc. if justified)	Select individual investment
2) Determine cost	Determine cost
3) Determine fair value	Also determine if there is any permanent diminution in value
4) Apply lower of cost and fair value; but this cannot be done on a "global basis" i.e. on an overall basis	Provide for permanent diminution in value and Can be done only on "individual investment basis", and not
5)Difference (cost less fair value) should be charged to P&L	Element of permanent diminution in value should be charged to P&L

6) Review periodically	Review periodically, ignore temporary fluctuations in the value.
7) Any subsequent increase in fair value can be credited to P&L, to the extent of original debit. In any case the carrying amount cannot exceed cost.	Any subsequent increase in market value can be credited to P&L, not exceeding original debit. In any case the carrying amount cannot exceed cost.

Disposal:

- On disposal of an investment, the difference between the carrying amount and the net disposal proceeds should be charged or credited to 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 holding of the investments.

1.9 : Reclassification: Intention To Hold Or To Sell Changes: The Standard envisages The possibilities of a Change in the intention to hold or not to hold an investment, and prescribes the valuation procedures. The change in intention can lead to.

- Investment originally treated as "long term" moving to "current", OR
- Investment originally treated as "current", moving to "long term" Accounting treatment in this regard is summarized in the following table.

Reclassification	
Long term to Current	**Current to Long term**
Take date of transfer as base	Take date of transfer as base
Determine *carrying amount* on such date	Determine fair value on such date
Determine cost	Determine cost
Apply lower of cost and carrying amount	Apply lower of cost and FV.

Disclosure Requirements: The disclosure requirements emanate from the key canons prescribed by the Standard, namely, Classification, Disposal, and Reclassification, and the impact on P&L. Disclosures to be made are:

a) Classification and grouping

- Disclose accounting policies for determination of carrying amount of investments
- If there are no statutory requirements for groupings (e.g. Schedule VI) of investments, category wise disclosure, namely, government securities, shares, debentures, etc., should be made.

b) Disposal

- Disclose separately, gains or losses on disposal of current investment, AS WELL AS of long term investments.

c) Reclassification

- Disclose changes in the carrying amount of both current and long term investments due to reclassification (or otherwise)

d) Impact on P & L (amount to be included)
- State gross amount of interest, dividends and rentals on investments
- Do not show NET of TDS. Include TDS under Advance Taxes
- Revenue flow from long term investment should be shown separately

e) Other areas
- The aggregate amount of quoted and unquoted investment, giving the aggregate market value of quoted investment
- Other disclosures as required by the relevant statue governing the enterprise.

Illustrations

Illustration 1

M/s Innovative Garments Manufacturing Company Limited invested in the shares of another company on 1st October, 2014 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, 2012. Market value as on 31st March, 2015 of above investments are as follows :

- Shares Rs.2,25,000
- Gold Rs.6,00,000
- Silver Rs.3,50,000

How will the above investments be shown in the books of accounts of M/s Innovative Garments Manufacturing Company Limited for the year ending 31st March, 2015 as per the provisions of Accounting Standard 13 "Accounting for Investments"?

Solution:

Investments	Value if Long Term	Value if Current Investments
Shares	Carried at Cost of Rs. 2,50,000 unless the drop in market value is permanent; if it is Permanent valued at Rs.2,25,000	Cost or Market Value which ever is lower, i.e Rs.2,25,000
Gold	Carried at Cost - Rs. 4 lacs	Carried at Cost - Rs. 4 lacs
Silver	Carried at Cost - Rs. 2 lacs	Carried at Cost - Rs. 2 lacs

AS-16- Borrowing Costs

1.0 Objective and Scope: The interest and other costs incurred before the asset is effectively used, is known as borrowing cost. AS-16 aims to provide accounting for borrowing costs. However, it does not deal with the actual or imputed cost of capital, both equity and preference.

2.0 Coverage Under AS-16 Excluded: The Standard does not apply to the following:

- Actual cost of owners' equity- including preference share capital, or
- Imputed cost of such equity,
- Other items forming part of equity and not classified as a liability.

The substance of AS-16 is that, by applying the matching and accrual concepts, borrowing costs can be capitalized as a part of the cost of a qualifying asset, within certain limits.

3.0 KEY TERMS USED

Borrowing costs

Borrowing costs are interest and other costs incurred by an enterprise in connection with the borrowing of funds, e.g.

a) Interest and commitment charges on bank borrowings and other short term and long-term borrowings;

b) amortization of discounts or premiums relating to borrowings;

c) amortization of ancillary costs incurred in connection with the arrangement of borrowings;

d) finance charges in respect of assets acquired under finance leases or under other similar arrangements; and

e) Exchange differences arising from foreign currency borrowings to the extent that they are regarded as an adjustment to interest costs.

Which exchange difference can be included in borrowing costs (Para 4(e) of AS 16)

- Exchange difference arising from foreign currency borrowings can be considered as borrowing cost to the extent of :

Interest on Local Currency Borrowing (notional principal)	-	Interest on Foreign Currency Borrowing

- If the exchange difference is more than the difference computed above, the balance will be accounted according to AS 11

- 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.

➢ **Example**

RGS Ltd. has raised a loan of $ 1,00,000 on 1-4-2008 for a specific project @ 6% p.a. payable annually. On 1-4-2008, the exchange rate is Rs. 48 per $. On 31-3-2009, the exchange rate is Rs. 50 per $. The corresponding amount could have been borrowed by RGS Ltd. in local currency @ 10% p.a. as on 1-4-2008.

In this case, the amount that can be included in the borrowing costs will be computed as under:

1) Interest for the period

   = $ 1,00,000 x 6% x 50 = Rs. 3,00,000

2) Increase in liability towards the principal amount/Exchange difference

   = $ 1,00,000 x 2 = Rs. 2,00,000

3) Interest that would have resulted if the loan was taken in local currency

   = $ 1,00,000 x 48 x 10% = Rs. 4,80,000

4) Difference between interest on local currency and foreign currency borrowing

= Rs. 1,80,000 (Rs. 4,80,000 – Rs. 3,00,000)

Thus, out of Rs. 2,00,000 increase in the liability towards principal amount, only Rs. 1,80,000 will be considered as the borrowing cost. Thus, the total borrowing costs would be Rs. 4,80,000 (Rs. 3,00,000 + Rs. 1,80,000). The remaining amount of Rs. 20,000 would be considered as the exchange difference to be accounted for as per AS 11 (Revised 2003).

Ministry of Corporate Affairs has clarified vide circular no. 25/ 2012 dated 09th August, 2012 that Para 49e) of AS 16 should not apply to a company which is applying Para 46A of AS 11 (refer chapter 11: AS on 'Effects of Changes in Foreign Exchange Rates', i.e., the entire foreign exchange arising on subsequent reporting of a long-term foreign currency monetary item will be either capitalized or transferred to FCMITDA, as the case may be.

- **Example**

XYZ Ltd. has taken a long-term loan of USD 10,000 on April 1, 2011 at an interest rate of 5% p.a., payable annually. On April 1, 2011, the exchange rate between the currencies was Rs. 45 per USD. The exchange rate, as at march 31, 2012, is Rs. 48 per USD. The corresponding amount could have been borrowed by XYZ Ltd. in local currency at an interest rate of 11 percent per annum as on April 1, 2011.

The following computation would be made to determine the amount of borrowing costs for the purposes of paragraph 4(e) of AS 16:

a) Interest for the period = USD 10,000 x 5% X Rs. 48 / USD = Rs. 24,000

b) Increase in the liability towards the principal amount = USD 10,000 x (48-45) = Rs. 30,000

c) Interest that would have resulted if the loan was taken in Indian currency = USD 10000 x 45 x 11% = Rs. 49,500

d) 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 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. The balance of Rs. 4,500 would be considered as the exchange difference to be accounted for as per AS 11. ***It may be noted here that this accounting treatment is valid if the company does not opt for Para 46A of AS 11.***

Borrowing costs of Rs. 49,500

Capitalize if in relation to a qualifying asset	Otherwise, charge to profit and loss account as on 'interest expense' under the head 'finance costs'
Foreign exchange loss of Rs. 4,500:	
Recognize as an expense in profit and loss account	

In case the company opts for Para 46A of AS 11:

Entire exchange difference of Rs. 30,000 will be accounted for under Para 46A of AS 11.

Foreign exchange loss of Rs. 30,000:	
If in relation to acquisition of a depreciable capital asset:	In any other case:
Add to the cost of the asset and depreciate over the balance life of the asset	Accumulate in FCMITDA and amortize over the balance period of such borrowings

Qualifying asset

It is an asset that necessarily takes a substantial period of time to get ready for its intended use (fixed asset) or sale (Inventory). **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.

However, if an asset is ready for its intended use or sale at the time of its acquisition then it is not treated as a qualifying asset for the purposes of AS 16, eg, if a ready building is acquired and put to use immediately, it is not a qualifying asset.

What is substantial period of time?

Ordinarily, a period of twelve months is considered as substantial period of time unless a shorter or longer period can be justified on the basis of facts and circumstances of the case. In estimating the period, time which an asset takes, technologically and commercially, to get ready for its intended use or sale should be considered.

The following assets ordinarily take twelve months or more to get ready for intended use or sale unless the contrary can be proved by the enterprise:

i. assets that are constructed or otherwise produced for an enterprise's own use, eg, assets constructed under major capital expansions;

ii. Assets intended for sale or lease that are constructed or otherwise produced as discrete projects, eg, ships or real estate developments.

Further, in case of inventories, substantial period of time is considered to be involved where time is the major factor in bringing about a change in the condition of inventories, eg, liquor is often kept in store for more than twelve months for maturing.

4.0 When should the borrowing costs be capitalized

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.

Conditions:

a) it is probable that they will result in future economic benefits;
b) Borrowing costs can be measured reliably.

If these conditions are not satisfied then the borrowing costs should be treated as an expense in the period in which they are incurred.

5.0 How to determine the amount to be capitalized when the funds have been borrowed specifically

When the funds have been borrowed specifically then the amount of borrowing costs to be capitalized is to be calculated as under:

- Ascertain actual borrowing costs [say (a)]
- Ascertain any income on the temporary investment of these borrowings [say (b)]
- Ascertain the borrowing costs to be capitalized by deducting (b) from (a),-

➢ **Example**

	Rs.
Amount borrowed	*10 crores*
Borrowing costs incurred (a)	*1.5 crores*
Income from temporary investment of funds During the period they were in surplus (b)	*0.2 crores*
Amount to be capitalized (a) – (b)	*1.3 crores*

6.0 How to determine the amount to be capitalized when the funds have been borrowed generally

- When the funds have been borrowed generally then the amount of borrowing costs to be capitalized is to be calculated by applying a capitalization rate to the expenditure on that asset.
- The capitalization rate, here, means the weighted average of the borrowing costs applicable to the borrowings of the enterprise that are outstanding during the period
- Borrowings made specifically for obtaining a qualifying asset should not be considered for computing the weighted average cost of borrowings.
- However, the amount of borrowing costs capitalized during a period should not exceed the amount of borrowing costs incurred during that period.

7.0 How to treat the excess of carrying amount of the qualifying asset over its recoverable amount

The carrying amount or the expected ultimate cost of a qualifying asset should not exceed its recoverable amount or net realizable value. In case it so exceeds, the carrying amount should be written down or written off as per AS 2 or AS 10, as the case may be. In certain circumstances, the amount so written down or written off can also be written back as per AS 2 or AS 10, as the case may be.

➢ **Example**

	2007-08
	Rs.
Carrying Amount	*1,00,000*
Recoverable amount	*84,000*
Written down to	*84,000*

Amount written off *16,000*

If in the year 2008-09, the recoverable amount becomes Rs. 96,000 then the carrying amount can be written back to Rs. 96,000. However, if the recoverable amount exceeds Rs. 1,00,000 (say Rs. 1,10,000) then the carrying amount cannot be increased beyond Rs. 1,00,000

8.0 When should capitalization commence

There are certain conditions that need to be satisfied for capitalization to commence. These conditions are:

a) Expenditure for the acquisition, construction or production of a qualifying asset is being incurred.

(For this purpose, only such expenditure as has resulted in payments of cash, transfers of other assets or the assumption of interest bearing liabilities will be included. Further, it will be reduced by progress payments, if any, received as well as grants received in connection with the asset in question.)

b) borrowing cost is being incurred; and

c) Activities which are necessary to prepare the asset for its intended use or sale are in progress.

Following **'Acid Test'** shall be applied to capitalize bon-owing costs:

1) There is borrowing.

2) Borrowing is directly attributable to Acquisition / production / construction of Asset.

3) That asset is qualifying Asset i.e., Asset requires substantial period of time to get ready for its intended use or sale. Thus Qualifying Asset may be Fixed Asset or Stock for sale. Generally a period of 12 months is considered as a substantial period of time

- ✓ If all above 3 conditions are fulfilled capitalize Borrowing cost i.e., add to acquisition cost of asset.

- ✓ Otherwise Borrowing Cost shall be treated as expense of the period and charged to Profit & Loss A/c.

Borrowing costs incurred while land is under development are capitalized 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 capitalization.

9.0 Suspension of Capitalization: Capitalization 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 capitalization.

Exceptions:

1) Capitalization of borrowing costs is not normally suspended 'during a period when substantial technical and administrative work is being carried out.

2) Capitalization 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, capitalization 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.

10.0 Cessation of Capitalization: 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 like decoration of a property to the user's specification, are all that are outstanding, this indicates that substantially all the activities are complete.

11.0 When the construction of a qualifying asset is completed in parts and a completed part is capable of being used while construction continues for the other parts, capitalization of borrowing costs in relation to a part should cease when substantially all the activities necessary to prepare that part 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 with in the same site, such as a steel mill.

12.0 Disclosure: AS —16 requires that the Financial statement should disclose:

a) The accounting policy adopted by the firm for borrowing costs; and

b) The amount of borrowing costs capitalized during the period.

13.0 ICAI Interpretations : ASI 1, 10

ASI 1: Substantial period of time: Ordinarily, **a period of twelve months** is considered as substantial period of time, unless a shorter or longer period can be justified on the basis of facts and circumstances of the case. Thus, a rebuttable presumption of a period of twelve months, is considered a "substantial" period of time. Para 4 (e) of AS-16 i.e. "Borrowing costs may include exchange differences arising from foreign currency borrowings to the extent that they are regarded as an adjustment to interest costs."

Land not Qualifying Asset: Interest on loan taken for the purpose of constructing building / cannot be capitalized as borrowing cost since land is not a Qualifying Asset, The fact that acquisition of land is an integral part of development of a property, would not make it a Qualifying Asset since each of the asset necessary for the project should be considered separately for the purpose of deciding whether it constitutes a 'Qualifying Asset' for AS-16 purposes. 'Land and Building' in a case are considered separate asset.	**Nov 2005 CA Journal**

Illustrations

Illustration 1:
GHI Limited obtained a loan for Rs.70 lacs on 15.4.2010 from JKL Bank to be utilised as under:

Construction of factory shed	Rs.25 lacs
Purchase of machinery	Rs.20 lacs
Working capital	Rs.15 lacs
Advance for purchase of truck	Rs.10 lacs
Total	**Rs.70 lacs**

On March 31st construction of factory shed was completed and machinery which was ready for its intended use was installed. Delivery of Truck was received in the next financial year.

Total interest of Rs.9.1 lacs was charged by the bank for FY11. Show the treatment of interest under AS 16 and explain the nature of asset

Solution1:

Treatment of Interest (Borrowing cost) as per AS 16 'Borrowing Costs'
Construction of Factory Shed:

If the period April 2010 to March 2011 is substantial period as per the Company's policy, then interest incurred on borrowings taken for such construction can be capitalised, if not such interest cost should be charged off to the P&L Interest attributable to Factory shed:

Rs. 9.1lacs x Rs.25 lacs /Rs. 70 lacs = Rs.3.25 lacs

Purchase of Machinery:

It is not a qualifying asset as it is ready for intended use on its purchase itself. The interest cost on same should be charged off to P&L: Rs. 9.1 lacs X 20/70 = Rs. 2.6 lacs

*Working Capital:*Interest cost on inventory can be capitalised if it takes substantial period of time. Working capital is generally a non-qualifying asset and interest cost on such working capital should be charged off: Rs. 9.1 lacs X 15/70 = Rs. 1.95 lacs

Advance for purchase of truck:

Even after delivery is made, if an asset takes substantial period of time to be ready for intended use only then will it be considered as a qualifying asset. Hence, truck is a non-qualifying asset and the interest pertaining to the loan will be debited to profit and loss account: Rs. 9.1 X 10/70 = Rs. 1.3 lacs.

Illustration 2:

Axe Ltd began construction of a new plant on 1.4.2011 and obtained a special loan of Rs.4 lacs to finance construction of the plant. Interest rate is 10%. Expenditure that was made on the project of plant was as follows:

1.4.2011	Rs. 5 lacs
1.8.2011	Rs. 12 lacs
1.1.2012	Rs. 2 lacs

The Company's other outstanding non-specific loan was Rs.23 lacs at interest rate of 12%. Construction of the plant completed on 31.3.2012. You are required to:

(a) Calculate the amount of interest to be capitalized as per the provisions of AS 16 "Borrowing Cost".

(b) Pass a journal entry for capitalizing the cost and the borrowing cost in respect of the plant.

Solution2:

Total expenses to be capitalized for borrowings as per AS 16 "Borrowing Costs":

	Rs.
Cost of Plant (5,00,000 + 12,00,000 + 2,00,000) *Add*: Amount of interest to be capitalised (W.N.1)	19,00,000 1,54,000
	20,54,000

Journal Entry

		Rs.	Rs.
31st March, 2012	Plant A/c Dr. To Bank A/c [Being amount of cost of plant and borrowing cost thereon capitalised]	20,54,000	20,54,000

Working Notes:
1. Computation of Interest

Date	Amount	Months	Rate	Interest
01.04.2011	4,00,000	12	10%	4,00,000 X 10% X12/12 =40,000
01.04.2011	1,00,000	12	12%	1,00,000 X 12% X 12/12 =12,000
01.08.2011	12,00,000	8	12%	12,00,000 X 12% X 8/12 =96,000
01.01.2012	2,00,000	3	12%	2,00,000 X 12% X 3/12 =6,000
	Total			Rs. 1,54,000

Illustration 3:

On 18th April, 2011, Amazing Construction Ltd. obtained a loan of Rs. 32 crores to be utilized 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 equipment 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 2012	Rs. 80,00,000

Show the treatment of interest by Amazing Construction Ltd.

Solution3:

According AS 16 'Borrowing costs', a qualifying asset is an asset that necessarily takes substantial period of time to get ready for its intended use or sale. 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.

In the given case, construction of sea-link is a qualifying asset. The capitalisation is continued for periods in which active development is stopped due to high water levels (which is common in construction of bridges).

Purchase of equipment and vehicles are not qualifying asset as they are generally ready for use at the time of purchase. Similarly, technical know-how are not qualifying assets.

Working capital for day to day operations of business is not qualifying asset.

The treatment of interest by Amazing Construction Ltd. can be shown as:

	Qualifying Asset	Interest to be Capitalized Rs.	Interest to be charged to Profit & Loss A/c Rs.	
Construction of sea-link	Yes	62,50,000		[80,00,000*(25/32)]
Purchase of equipment and machinery	No		7,50,000	[80,00,000*(3/32)]
Working capital	No		5,00,000	[80,00,000*(2/32)]
Purchase of vehicles	No		1,25,000	[80,00,000*(.5/32)]
Advance for tools, cranes etc.	No		1,25,000	[80,00,000*(.5/32)]
Purchase of technical knowhow	No		2,50,000	[80,00,000*(1/32)]
Total		**62,50,000**	**17,50,000**	

Illustration 4:

Suhana limited issued 12% secured debentures of Rs.100 lacs on 1.5.2013 to be utilised as under:

- Construction of factory building – Rs.40 lacs
- Purchase of Machinery – Rs.35 lacs
- Working Capital Rs.25 lacs

In March 2014 construction of factory building was completed and Machinery was installed and is ready for its intended use.

Total interest on debentures for FY14 was 11 lacs. During the year 13-14, the company had invested idle funds out the money raised from debentures in Bank FDs and earned interest of Rs.2 lacs. Show the treatment of interest under AS 16 and explain the nature of asset.

Solution 4:

According to 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.

Also para 10 of AS 16 “Borrowing Costs” states that to the extent that funds are borrowed specifically for the purpose of obtaining a qualifying asset, the amount of borrowing costs eligible for 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.

Thus, eligible borrowing cost = Rs. 11,00,000 - Rs. 2,00,000 = Rs. 9,00,000

S.No.	Particulars	Nature of assets	Interest to be Capitalized (Rs.)	Interest to be charged to Profit & Loss Account (Rs.)
1	Construction of factory building	Qualifying Asset*	9,00,000x40/100 = Rs. 3,60,000	NIL
2	Purchase of Machinery	Not a Qualifying Asset	NIL	9,00,000x 35/100 = Rs.3,15,000
3	Working Capital	Not a Qualifying Asset	NIL	9,00,000x 25/100 = Rs. 2,25,000
	Total		**Rs. 3,60,000**	**Rs. 5,40,000**

* A qualifying asset is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale.

Illustration.5

Shan Builders Limited has borrowed a sum of US $ 10,00,000 at the beginning of Financial Year 2014-15 for its residential project at LIBOR + 3 %. The interest is payable at the end of the Financial Year. At the time of availing the loan, exchange rate was Rs. 56 per US $ and the rate as on 31st March,2015 was Rs. 62 per US $. If Shan Builders Limited had borrowed the loan in India in Indian Rupee equivalent, the pricing of loan would have been 10.50%. Compute Borrowing Cost and exchange difference for the year ending 31st March, 2015 as per applicable Accounting Standards. (Applicable LIBOR is 1%).

Solution5:

(i) Applicable interest rate : 1% +3% = 4%

Interest for the period 2014-15 = US $10,00,000 x 4% × Rs. 62 per US $ = Rs. 24.80 lakhs

(ii) Increase in the liability towards the principal amount = US $ 10,00,000 × Rs. (62 - 56) = Rs. 60,00,000

(iii) Interest that would have resulted if the loan was taken in Indian currency = US $ 10,00,000 × Rs. 56 x 10.5% = Rs. 58,80,000

(iv) Difference between interest on local currency borrowing and foreign currency borrowing = Rs. 58,80,000– Rs. 24,80,000 = Rs.34,00,000.

Borrowing Costs include exchange differences arising from foreign currency borrowings To the extent that they are regarded as an adjustment to interest costs. Therefore, out of exchange fluctuation loss of Rs.60 lakhs towards principal amount, only Rs. 34 lakhs will be considered as the borrowing cost.
Total Borrowing Cost = Rs. 24,80,000 + Rs. 34,00,000 = Rs. 58,80,000

Hence, Rs. 58.80 lakhs would be considered as the borrowing cost to be accounted for as per AS 16 "Borrowing Costs" and the remaining Rs. 26 lakhs (60 - 34) would be considered as the exchange difference to be accounted for as per AS 11 "The Effects of Changes in Foreign Exchange Rates".

Illustration 6

M/s First Limited began a construction of a new building on 1.4.2017. It obtained Rs. 2 lakh as a special loan to finance the construction of a factory buildings on 1.1.2017 at an interest rate of 8% per annum.

Further, expenditure on construction of the factory building was financed through other non-specific loans.

Details of the company's other outstanding non-specific loans were:

Loan	Rate of Interest
Rs.4,00,000	9%
Rs.5,00,000	12%
Rs.3,00,000	14%

The expenditure that was made on the buildings project were as follows:

Date	Expenditure on buildings
1st April 2017	Rs.3,00,000
31st May 2017	Rs. 2,40,000
1st Aug 2017	Rs. 4,00,000
31st Dec 2017	Rs.3,60,000

Construction of Building was completed by 31.03.2018. As per the provisions of AS-16, you are

required to:

1. Calculate the amount of interest to be capitalized and

2. Pass Journal entry for capitalizing the cost and borrowing cost in respect of the factory building

Solution

If it is assumed that the specific loan is used for the first expense of the project

A. of average accumulated expenses

Loan Date	Computation	Avg. Expenses	Interest @ 11.5%
1st Apr	1,00,000 x 12/12	1,00,000	11,500
31st May	2,40,000 x 10/12	2,00,000	23,000
1st Aug	4,00,000 x 8/12	2,66,667	30,667
31st Dec	3,60,000 x 3/12	90,000	10,350
		6,56,667	75,517

B. Interest on specific loan of Rs.2,00,000 @ 8% on total period = 16,000

Interest to be capitalised(A+B) = Rs.91,517

Illustration 7

In May, 2016, Capacity Ltd. took a bank loan to be used specifically for the construction of a new factory building. The construction was completed in January, 2017 and the building was put to its use immediately thereafter.

Interest on the actual amount used for construction of the building till its completion was Rs. 18 lakhs, whereas the total interest payable to the bank on the loan for the period till 31st March, 2017 amounted to Rs. 25 lakhs.

Can Rs. 25 lakhs be treated as part of the cost of factory building and thus be capitalized on the plea that the loan was specifically taken for the construction of factory building?

Explain the treatment in line with the provisions of AS 16.

Solution

Given

- Qualifying Asset – Factory Building
- Loan Taken – May 2016
- Asset ready for intended use & put to use – January 2017
- Interest till January 2017 – Rs.18,00,000
- Interest till 31st March 2017 – Rs.25,00,000

AS 16 clearly states that capitalization of borrowing costs should cease when substantially all the activities necessary to prepare the qualifying asset for its intended use are completed.

Conclusion - Therefore, interest on the amount that has been used for the construction of the building up to the date of completion (January, 2017)

- Rs. 18 lakhs alone can be capitalized.
- Rs. 25 lakhs will be charged to P&L a/c as interest expense

Illustration 8

A company incorporated in June 2017, has setup a factory within a period of 8 months with borrowed funds. The construction period of the assets had reduced drastically due to usage of technical innovations by the company. Whether interest on borrowings for the period prior to the date of setting up the factory should be capitalized although it has taken less than 12 months for the assets to get ready for use. You are required to comment on the necessary treatment with reference to AS 16.

Solution:
As per para 3.2 to AS 16 'Borrowing Costs', a qualifying asset is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale.

It is a rebuttable presumption that 12 months period constitutes substantial period of time. Ordinarily, a period of 12 months is considered as substantial period of time unless a shorter or longer period can be justified on the basis of facts and circumstances of the case considering the time which an asset takes, technologically and commercially, to get it ready for its intended use or sale, which the management might decide as an accounting policy.

Therefore, if the factory is constructed in 8 months then it shall be considered as a qualifying asset. The interest on borrowings for the same shall be capitalised although it has taken less than 12 months for the asset to get ready to use. An enterprise that completes the asset in 8 months should not be penalized for its efficiency by denying it interest capitalization and vice versa.

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