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ACCOUNTING STANDARDS AND GUIDANCE NOTES

UNIT 1: INTRODUCTION TO ACCOUNTING STANDARDS

Accounting Standards (ASs) are written policy documents issued by expert accounting body or by government or other regulatory body covering the aspects of recognition, measurement, treatment, presentation and disclosure of accounting transactions in the financial statements.

1.1 Objectives of Accounting Standards

Accounting as a 'language of business' communicates the financial results of an enterprise to various stakeholders by means of financial statements. If the financial accounting process is not properly regulated, there is possibility of financial statements being misleading, tendentious and providing a distorted picture of the business, rather than the true state of affairs. In order to ensure transparency, consistency, comparability, adequacy and reliability of financial reporting, it is essential to standardize the accounting principles and policies. Accounting Standards provide framework and standard accounting policies so that the financial statements of different enterprises become comparable.

The Accounting Standards reduce the accounting alternatives in the preparation of rational financial statements thereby ensuring comparability of financial statements of different enterprises. The Accounting Standards deal with the issues of

(i) recognition of events and transactions in the financial statements,

(ii) measurement of these transactions and events,

(iii) presentation of these transactions and events in the financial statements in a manner that is meaningful and understandable to the reader, and

(iv) the disclosure requirements which should be there to enable the public at large and the stakeholders and the potential investors in particular, to get an insight into these financial statements which helps the users to take prudent and informed business decisions.

The objective of Accounting Standards is to standardize diverse accounting policies with a view to eliminate, to the maximum possible extent,

(i) the non-comparability of financial statements and thereby improving the reliability of financial statements, and

(ii) to provide a set of standard accounting policies, valuation norms and disclosure requirements.

The Institute of Chartered Accountants of India (ICAI), being a premier accounting body in the country, took upon itself the leadership role by constituting the Accounting Standards Board (ASB) in 1977. The ICAI has taken significant initiatives in the setting and issuing procedure of Accounting Standards to ensure that the standard-setting process is fully consultative and transparent. The ASB considers the International Accounting Standards (IASs)/International Financial Reporting Standards (IFRSs) while framing Indian Accounting Standards (ASs) and try to integrate them, in the light of the applicable laws, customs, usages and business environment in the country. The concept of Accounting Standards and the standards setting process in India has already been discussed, in detail, in IPCC Accounting Study Material – Chapter 1.

1.2 Benefits and Limitations

Accounting standards seek to describe the accounting principles, the valuation techniques and the methods of applying the accounting principles in the preparation and presentation of financial statements so that they may give a true and fair view. By setting the accounting standards the accountant has following benefits:

(i) Standards reduce to a reasonable extent or eliminate altogether confusing variations in the accounting treatments used to prepare financial statements.

(ii) There are certain areas where important information are not statutorily required to be disclosed. Standards may call for disclosure beyond that required by law.

(iii) The application of accounting standards would, to a limited extent, facilitate comparison of financial statements of companies situated in different parts of the world and also of different companies situated in the same country. However, it should be noted in this respect that differences in the institutions, traditions and legal systems from one country to another give rise to differences in accounting standards adopted in different countries.

However, there are some limitations of setting of accounting standards:

(i) Alternative solutions to certain accounting problems may each have arguments to recommend them. Therefore, the choice between different alternative accounting treatments may become difficult.

(ii) There may be a trend towards rigidity and away from flexibility in applying the accounting standards.

(ii) Accounting standards cannot override the statute. The standards are required to be framed within the ambit of prevailing statutes.

1.3 Standard-Setting Process

The need for accounting standards specifically suitable for the country's economic environment was also felt in India. Recognising the need to harmonise the diverse accounting policies and practices in India and keeping in view the international developments in the field of accounting, the Council of the Institute of Chartered Accountants of India (ICAI) constituted the Accounting Standards Board (ASB) on 21st April, 1977. The composition of ASB is broad based to ensure due representation and the participation of all those who are interested in the formulation and implementation of these standards. Apart from the elected members of the Council of the ICAI nominated on the ASB, there are various Central Government nominees, nominees from various other professional institutes like the Institute of Cost and Works Accountants of India, Institute of Company Secretaries of India, Representatives of Industry Associations, Reserve Bank of India, Securities and Exchange Board of India, Controller General of Accounts, Central Board of Excise and Customs, Representative of Academic and Financial Institutions, other eminent professionals co-opted by the ICAI and any representative(s) of other body, as considered appropriate by the ICAI.

The preliminary drafts of the standards are prepared by the Study Groups which take up specific subjects assigned to them. The draft so prepared is considered by ASB and sent to various outside bodies like FICCI, ASSOCHAM, SCOPE, CLB, C & AG, ICWAI, ICSI, CBDT etc. After taking into consideration their views, the draft of the standards is issued as an Exposure Draft (ED) for comments by members of ICAI and the public at large. The comments on the ED are considered by ASB and a final draft of the standard is submitted to the Council of the ICAI for its approval and is thereafter issued as a definitive standard.

1.4 How Many Accounting Standards?

The council of the Institute of Chartered Accountants of India has, so far, issued thirty two Accounting Standards. However, AS 8 on ‘Accounting for Research and Development’ has been withdrawn consequent to the issuance of AS 26 on ‘Intangible Assets’. Thus effectively, there are 32 Accounting Standards at present. The ‘Accounting Standards’ issued by the Accounting Standards Board establish standards which have to be complied by the business entities so that the financial statements are prepared in accordance with generally accepted accounting principles.

1.5 Applicability of Accounting Standards

For the purpose of compliance of the accounting Standards, ICAI issued an announcement ‘Applicability of Accounting Standards’. As per the announcement, there are three levels of entities. Level II entities and Level III entities as per the said Announcement are considered to be the Small and Medium Entities (SMEs). On the other hand, as per the Accounting Standards notified by the Government, there are two levels, namely, Small and Medium-sized Companies (SMCs) as defined in the Rules and companies other than SMCs. Non-SMCs are required to comply with all the Accounting Standards in their entirety, while certain exemptions/ relaxations have been given to SMCs. Certain differences in the criteria for classification of the levels were also noted.

In this regard, the ASB of the ICAI decided to continue to have three levels as at present with certain modification, instead of two as per the Government notification.

1.5.1 Criteria for classification of non-corporate entities as decided by the Institute of Chartered Accountants of India

Level I Entities

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

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

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

(iii) All commercial, industrial and business reporting entities, whose turnover (excluding other income) exceeds rupees fifty crore in the immediately preceding accounting year.

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

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

Level II Entities (SMEs)

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

(i) All commercial, industrial and business reporting entities, whose turnover (excluding other income) exceeds rupees forty lakh but does not exceed rupees fifty crore in the immediately preceding accounting year.

(ii) All commercial, industrial and business reporting entities having borrowings (including public deposits) in excess of rupees one crorebut not in excess of rupees ten crore at any time during the immediately preceding accounting year.

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

Level III Entities (SMEs)

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

Additional requirements

(1) An SME which does not disclose certain information pursuant to the exemptions or relaxations given to it should disclose (by way of a note to its financial statements) the fact that it is an SME and has complied with the Accounting Standards insofar as they are applicable to entities falling in Level II or Level III, as the case may be.

(2) Where an entity, being covered in Level II or Level III, had qualified for any exemption or relaxation previously but no longer qualifies for the relevant exemption or relaxation in the current accounting period, the relevant standards or requirements become applicable from the current period and the figures for the corresponding period of the

previous accounting period need not be revised merely by reason of its having ceased to be covered in Level II or Level III, as the case may be. The fact that the entity was covered in Level II or Level III, as the case may be, in the previous period and it had availed of the exemptions or relaxations available to that Level of entities should be disclosed in the notes to the financial statements.

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

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

(5) If an entity covered in Level II or Level III desires to disclose the information not required to be disclosed pursuant to the exemptions or relaxations available to that Level of entities, it should disclose that information in compliance with the relevant Accounting Standard.

(6) An entity covered in Level II or Level III 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.

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

1.5.2 Criteria for classification of Companies under the Companies (Accounting Standards) Rules, 2006: Small and Medium-Sized Company (SMC) as defined in Clause 2(f) of the Companies (Accounting Standards) Rules, 2006:

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

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

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

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

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

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

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

Non-SMCs

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

Instructions

A. General Instructions

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

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

   "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, 1956. Accordingly, the Company has complied with the Accounting Standards as applicable to a Small and Medium Sized Company."

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

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

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

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

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

B. Other Instructions

Rule 5 of the Companies (Accounting Standards) Rules, 2006, provides as below:

"5. An existing company, which was previously not a Small and Medium Sized Company (SMC) and subsequently becomes an SMC, shall not be qualified for exemption or relaxation in respect of Accounting Standards available to an SMC until the company remains an SMC for two consecutive accounting periods."

1.5.3 Applicability of Accounting Standards to Companies

1.5.3.1 Accounting Standards applicable to all companies in their entirety for accounting periods commencing on or after 7th December, 2006

AS 1	Disclosures of Accounting Policies
AS 2	Valuation of Inventories
AS 4	Contingencies and Events Occurring After the Balance Sheet Date
AS 5	Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies
AS 6	Depreciation Accounting
AS 7	Construction Contracts (revised 2002)
AS 9	Revenue Recognition
AS 10	Accounting for Fixed Assets
AS 11	The Effects of Changes in Foreign Exchange Rates (revised 2003)
AS 12	Accounting for Government Grants
AS 13	Accounting for Investments
AS 14	Accounting for Amalgamations
AS 16	Borrowing Costs
AS 18	Related Party Disclosures
AS 22	Accounting for Taxes on Income
AS 24	Discontinuing Operations
AS 26	Intangible Assets

1.5.3.2 Exemptions or Relaxations for SMCs as defined in the Notification

(A) Accounting Standards not applicable to SMCs in their entirety:

AS 3 Cash Flow Statements.

AS 17 Segment Reporting

(B) Accounting Standards not applicable to SMCs since the relevant Regulations require compliance with them only by certain Non-SMCs[*]:

[*] AS 21, AS 23 and AS 27 (relating to consolidated financial statements) are required to be complied with by a company if the company, pursuant to the requirements of a statute/regulator or voluntarily, prepares and presents consolidated financial statements.

(i) AS 21, Consolidated Financial Statements

(ii) AS 23, Accounting for Investments in Associates in Consolidated Financial Statements

(iii) AS 27, Financial Reporting of Interests in Joint Ventures (to the extent of requirements relating to Consolidated Financial Statements)

(C) Accounting Standards in respect of which relaxations from certain requirements have been given to SMCs:

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

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

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

(c) recognition and measurement principles laid down in paragraphs 50 to 116 and presentation and disclosure requirements laid down in paragraphs 117 to 123 of the Standard in respect of accounting for defined benefit plans. However, such companies should actuarially determine and provide for the accrued liability in respect of defined benefit plans by using the Projected Unit Credit Method and the discount rate used should be determined by reference to market yields at the balance sheet date on government bonds as per paragraph 78 of the Standard. Such companies should disclose actuarial assumptions as per paragraph 120(l) of the Standard; and

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

(ii) AS 19, Leases

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

(iii) AS 20, Earnings Per Share

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

(iv) AS 28, Impairment of Assets

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

(v) AS 29, Provisions, Contingent Liabilities and Contingent Assets

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

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

1.5.4 Applicability of Accounting Standards to Non-corporate Entities (As on 1.4.2008)

1.5.4.1 Accounting Standards applicable to all Non-corporate Entities in their entirety (Level I, Level II and Level III)

AS 1	Disclosures of Accounting Policies
AS 2	Valuation of Inventories
AS 4	Contingencies and Events Occurring After the Balance Sheet Date
AS 5	Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies
AS 6	Depreciation Accounting
AS 7	Construction Contracts (revised 2002)
AS 9	Revenue Recognition
AS 10	Accounting for Fixed Assets
AS 11	The Effects of Changes in Foreign Exchange Rates (revised 2003)
AS 12	Accounting for Government Grants
AS 13	Accounting for Investments
AS 14	Accounting for Amalgamations
AS 16	Borrowing Costs
AS 22	Accounting for Taxes on Income
AS 26	Intangible Assets

1.5.4.2 Exemptions or Relaxations for Non-corporate Entities falling in Level II and Level III (SMEs)

(A) Accounting Standards not applicable to Non-corporate Entities falling in Level II in their entirety:

AS 3	Cash Flow Statements
AS 17	Segment Reporting

(B) Accounting Standards not applicable to Non-corporate Entities falling in Level III in their entirety:

AS 3	Cash Flow Statements
AS 17	Segment Reporting
AS 18	Related Party Disclosures
AS 24	Discontinuing Operations

(C) Accounting Standards not applicable to all Non-corporate Entities since the relevant Regulators require compliance with them only by certain Level I entities:

(i)	AS 21, Consolidated Financial Statements
(ii)	AS 23, Accounting for Investments in Associates in Consolidated Financial Statements
(iii)	AS 27, Financial Reporting of Interests in Joint Ventures (to the extent of requirements relating to Consolidated Financial Statements)

(D) Accounting Standards in respect of which relaxations from certain requirements have been given to Non-corporate Entities falling in Level II and Level III (SMEs):

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

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

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

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

(c) recognition and measurement principles laid down inparagraphs 50 to 116 and presentation and disclosure requirements laid down in paragraphs 117 to 123 of the Standard in respect of accounting for defined benefit plans. However, such entities should actuarially determine and provide for the accrued liability in respect of defined benefit plans by using the Projected Unit Credit Method and the discount rate used should be determined by reference to market yields at the balance sheet date on government bonds as per paragraph 78 of the Standard. Such entities should disclose actuarial assumptions as per paragraph 120(l) of the Standard; and

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

(2) Level II and Level III Non-corporate entities whose average number of persons employed during the year is less than 50 are exempted from the applicability of the following paragraphs:

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

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

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

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

(ii) AS 19, Leases

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

(iii) AS 20, Earnings Per Share

Diluted earnings per share (both including and excluding extraordinary items) is not required to be disclosed by non-corporate entities falling in Level II and Level III and information required by paragraph 48(ii) of AS 20 is not required to be disclosed by Level III entities if this standard is applicable to these entities.

(iv) AS 28, Impairment of Assets

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

(v) AS 29, Provisions, Contingent Liabilities and Contingent Assets

Paragraphs 66 and 67 relating to disclosures are not applicable to noncorporate entities falling in Level II and Level III.

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

1.6 List of Accounting Standards

Following is the list of Accounting Standards with their respective date of applicability along with the scope.

AS No.	*AS Title*	*Date*	*Scope*
1	Disclosure of Accounting Policies	01/04/1993	All Level
2	Valuation of Inventories (Revised)	01/04/1999	All Level
3	Cash Flow Statement (Revised)	01/04/2001	Level I
4	Contingencies and Events Occurring after the Balance Sheet Date	01/04/1998	All Level
5	Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies (Revised)	01/04/1996	All Level
6	Depreciation Accounting (Revised)	01/04/1995	All Level
7	Construction Contracts (Revised)	01/04/2002	All Level

8	Research & Development	Now included	in AS – 26
9	Revenue Recognition	01/04/1993	All Level
10	Accounting for Fixed Assets	01/04/1993	All Level
11	The Effects of Changes in Foreign Exchange Rates (Revised)	01/04/2004	All Level
12	Accounting for Government Grants	01/04/1994	All Level
13	Accounting for Investments	01/04/1995	All Level
14	Accounting for Amalgamations	01/04/1995	All Level
15	Employee Benefits	01/04/2006	All Level
16	Borrowing Costs	01/04/2000	All Level
17	Segment Reporting	01/04/2001	Level I
18	Related Party Disclosures	01/04/2001	Level I
19	Leases	01/04/2001	All Level
20	Earning Per Shares	01/04/2001	Level I
21	Consolidated Financial Statement	01/04/2001	Enterprises preparing CFS*
22	Accounting for Taxes on Income	01/04/2001	Listed Companies
		01/04/2002	Other Companies
		01/04/2006	All Enterprises
23	Accounting for Investment in Associates in Consolidated Financial Statements	01/04/2002	Enterprises preparing CFS
24	Discontinuing Operations	01/04/2004	Level I
25	Interim Financial Statement	01/04/2002	Level I
26	Intangible Assets	01/04/2003	All Level
27	Financial Reporting of Interests in Joint Ventures	01/04/2002	Enterprises preparing CFS
28	Impairment of Assets	01/04/2004	Level I
		01/04/2006	Level II
		01/04/2008	Level III
29	Provisions, Contingent Liabilities and Contingent Assets	01/04/2004	All Level
30	Financial Instruments: Recognition and Measurement and Limited Revisions to AS 2, AS 11(revised 2003), AS 21, AS 23, AS 26, AS 27, AS 28 and AS 29.	01/04/2009 (Recommendatory) 01/04/2011 (Mandatory)	All (except to a SME)

* CFS has been written for cash flow statement.

31	Financial Instruments: Presentation	01/04/2009 (Recommendatory) 01/04/2011 (Mandatory)	All (except to a SME)
32	Financial Instruments: Disclosure and Limited Revision to AS 19	01/04/2009 (Recommendatory) 01/04/2011 (Mandatory)	All (except to a SME)

All of the above mentioned standards AS 1 to AS 32 (excluding AS 8) will be discussed in detail in the succeeding units of this chapter.

1.7 Accounting Standard Interpretations

The Accounting Standard Interpretations address questions that arise in course of application of a standard. These are therefore issued after issue of the relevant standard. Authority of an interpretation is same as that of the Accounting Standard to which it relates. So far, 30 interpretations have been issued.

A brief summary of these interpretations is given below. The readers may refer appropriate chapters for details.

No.	*Related AS*	*Topic*
1.	16	Interpretation of the term 'substantial period'
2.	10	Accounting for Machinery Spares
3.	22	Computation of deferred tax during tax holiday u/s 80-IA and 80-IB (Revised)
4.	22	Computation of deferred tax in respect of losses under the head Capital Gains
5.	22	Computation of deferred tax during tax holiday u/s 10A and 10B
6.	22	Computation of current and deferred tax subject to MAT u/s 115JB
7.	22	Disclosure of deferred tax assets/liabilities in balance sheet
8.	21, 23, 27	Interpretation of the term 'near future'
9.	22	Interpretation of the term 'virtual certainty'
10.	16	Computation of exchange difference to be treated as borrowing cost
11.	22	Accounting for Taxes on Income in case of an Amalgamation
12.	20	Applicability of AS 20 to unlisted companies
13.	18	Aggregation of related party disclosures
14.	9	Manner of disclosure of excise duty
15.	21	Notes to the Consolidated Financial Statements (CFS)
16.	23	Treatment in CFS: Dividend proposed by an associate
17.	23	Treatment in CFS: Changes in equity not included in P & L A/c

18.	23	Consideration of potential equity to ascertain whether the investee is an associate
19.	18	Interpretation of the term 'intermediary'
20.	17	Disclosure of segment information in certain cases (Revised)
21.	18	Non-executive directors; whether related parties
22.	17	Interest expenses; whether to treat as segment expenses
23.	18	Remuneration paid to key management personnel; whether related party transaction
24.	21	Subsidiaries having two parents
25.	21	Shares held as stock-in-trade
26.	21	Consolidation of current and deferred tax
27.	25	Applicability of AS 25
28.	21, 27	Disclosure of post-acquisition reserves in Consolidated Financial Statements
29.	7	Turnover in case of contractors
30.	29	Applicability of AS 29 to onerous contracts

In December, 2006, the Central Government notified the accounting standards issued by the ICAI in consultation with the NACAS. In the notified standards, the Central Government has included the consensus portion of certain Accounting Standard Interpretations (ASIs) as 'Explanation' to the relevant paragraphs as indicated below:

ASI No.	*Title of the ASI*	*Relevant Paragraph(s) of the Accounting Standards*
1	Substantial Period of Time (Re. AS 16)	Paragraph 3.2 of Accounting Standard (AS) 16, *'Borrowing Costs'*
3	Accounting for Taxes on Income in the situations of Tax Holiday under Sections 80-IA and 80-IB of the Income-tax Act, 1961 (Re. AS 22)	Paragraph 13 of Accounting Standard (AS) 22, '*Accounting for Taxes on Income'*
4	Losses under the head Capital Gains (Re. AS 22)	Explanation 2 to paragraph 17 of Accounting Standard (AS) 22, '*Accounting for Taxes on Income'*
5	Accounting for Taxes on Income in the situations of Tax Holiday under Sections 10A and 10B of the Income-tax Act, 1961 (Re. AS 22)	Paragraph 13 of Accounting Standard (AS) 22, '*Accounting for Taxes on Income'*
6	Accounting for Taxes on Income in the context of Section 115JB of the Income-tax Act, 1961 (Re. AS 22)	Paragraph 21 of Accounting Standard (AS) 22, '*Accounting for Taxes on Income'*
7	Disclosure of deferred tax assets and deferred tax liabilities in the balance	Paragraph 30 of Accounting Standard (AS) 22, '*Accounting for Taxes on*

	sheet of a company (Re. AS 22)	*Income'*
8	Interpretation of the term 'Near Future' (Re. AS 21, AS 23 and AS 27)	Explanation (b) to paragraph 11 of Accounting Standard (AS) 21, '*Consolidated Financial Statements'* Paragraph 7 of Accounting Standard (AS) 23, '*Accounting for Investments in Associates in Consolidated Financial Statements'* Paragraph 28 of Accounting Standard (AS) 27, '*Financial Reporting of Interests in Joint Ventures'*
9	Virtual certainty supported by convincing evidence (Re. AS 22)	Explanation 1 to paragraph 17 of Accounting Standard (AS) 22, '*Accounting for Taxes on Income'*
10	Interpretation of paragraph 4(e) of AS 16 (Re. AS 16)	Paragraph 4(e) of Accounting Standard (AS) 16, *'Borrowing Costs'*
13	Interpretation of paragraphs 26 and 27 of AS 18 (Re. AS 18)	Paragraphs 26 and 27 of Accounting Standard (AS) 18, *'Related Party Disclosures'*
14	Disclosure of Revenue from Sales Transactions (Re. AS 9)	Paragraph 10 of Accounting Standard (AS) 9, *'Revenue Recognition'*
15	Notes to the Consolidated Financial Statements (Re. AS 21)	Paragraph 6 of Accounting Standard (AS) 21, *'Consolidated Financial Statements'*
16	Treatment of Proposed Dividend under AS 23 (Re. AS 23)	Explanation (b) to paragraph 6 of Accounting Standard (AS) 23, *'Accounting for Investments in Associates in Consolidated Financial Statements'*
17	Adjustments to the Carrying Amount of Investment arising from Changes in Equity not Included in the Statement of Profit and Loss of the Associate (Re. AS 23)	Explanation (a) to Paragraph 6 of Accounting Standard (AS) 23, *'Accounting for Investments in Associates in Consolidated Financial Statements'*
18	Consideration of Potential Equity Shares for Determining whether an Investee is an Associate under AS 23 (Re. AS 23)	Paragraph 4 of Accounting Standard (AS) 23, *'Accounting for Investments in Associates in Consolidated Financial Statements'*
19	Interpretation of the term 'intermediaries' (Re. AS 18)	Paragraph 13 of Accounting Standard (AS) 18, *'Related Party Disclosures'*
20	Disclosure of Segment Information (Re. AS 17)	Paragraph 38 of Accounting Standard (AS) 17, *'Segment Reporting'*

21	Non-Executive Directors on the Board-whether related parties (Re. AS 18)	Paragraph 14 of Accounting Standard (AS) 18, *'Related Party Disclosures'*
22	Treatment of Interest for determining Segment Expense (Re. AS 17)	Point (b) of the definition of 'Segment Expense' under paragraph 5.6 of Accounting Standard (AS) 17, *'Segment Reporting'*
24	Definition of 'Control' (Re. AS 21)	Paragraph 10 of Accounting Standard (AS) 21, *'Consolidated Financial Statements'*
25	Exclusion of a subsidiary from consolidation (Re. AS 21)	Explanation (a) to paragraph 11 of Accounting Standard (AS) 21, *'Consolidated Financial Statements'*
26	Accounting for taxes on income in the consolidated financial statements (Re. AS 21)	Explanation (a) to paragraph 13 of Accounting Standard (AS) 21, *'Consolidated Financial Statements'*
28	Disclosure of parent's/venturer's shares in post-acquisition reserves of a subsidiary/jointly controlled entity (Re. AS 21 and AS 27)	Explanation (b) to paragraph 13 of Accounting Standard (AS) 21, *'Consolidated Financial Statements'* Paragraph 32 of Accounting Standard (AS) 27, *'Financial Reporting of Interests in Joint Ventures'*
30	Applicability of AS 29 to Onerous Contracts (Re. AS 29)	Paragraph 1(b) of Accounting Standard (AS) 29, *'Provisions, Contingent Liabilities and Contingent Assets'*

On the basis of the above, the ASB of ICAI has also incorporated the consensus portion of the above mentioned ASIs as 'Explanation' to the relevant paragraphs of the Accounting Standards.

Following ASIs have not been included in the notified Accounting Standards:

(i) ASI 2 Accounting for Machinery Spares (Re. AS 2 and AS 10)

(ii) ASI 11 Accounting for Taxes on Income in case of an Amalgamation (Re. AS 22)

(iii) ASI 12 Applicability of AS 20 (Re. AS 20)

(iv) ASI 23 Remuneration paid to key management personnel – whether a related party transaction (Re. AS 18)

(v) ASI 27 Applicability of AS 25 to Interim Financial Results (Re. AS 25)

(vi) ASI 29 Turnover in case of Contractors (Re. AS 7 (revised 2002))

The Council decided to withdraw the above ASIs and issue the same as Guidance Notes except ASI 2 and ASI 11. Guidance Notes are being separately issued.

UNIT 2 : AS 1 : DISCLOSURE OF ACCOUNTING POLICIES

Reference: The students are advised to refer the full text of AS 1 "Disclosure of Accounting Policies" given in Appendix I at the end of the Study Material (Volume-II).

2.1 Introduction

Irrespective of extent of standardisation, diversity in accounting policies is unavoidable for two reasons. First, accounting standards cannot and do not cover all possible areas of accounting and enterprises have the freedom of adopting any reasonable accounting policy in areas not covered by a standard. Second, since enterprises operate in diverse situations, it is impossible to develop a single set of policies applicable to all enterprises for all time. The accounting standards therefore permit more than one policy even in areas covered by it. Differences in accounting policies lead to differences in reported information even if underlying transactions are same. The qualitative characteristic of comparability of financial statements therefore suffers due to diversity of accounting policies. Since uniformity is impossible, and accounting standards permit more than one alternative in many cases, it is not enough to say that all standards have been complied with. For these reasons, accounting standard 1 requires enterprises to disclose accounting policies actually adopted by them in preparation of their financial statements. Such disclosures allow the users of financial statements to take the differences in accounting policies into consideration and to make necessary adjustments in their analysis of such statements.

AS 1 deals with the disclosure of significant accounting policies followed in preparing and presenting financial statements. The purpose of the Standard 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.

2.2 Accounting Policies

The accounting policies refer to the specific accounting principles and the methods of applying those principles adopted by the enterprise in the preparation and presentation of financial statements.

Accountant has to make decisions from various options for recording or disclosing items in the books of accounts e.g.:

Items to be disclosed	*Method of disclosure or valuation*
Inventories	FIFO, LIFO, Weighted Average etc.
Cash Flow Statement	Direct Method, Indirect Method
Contingent Liabilities/Assets	Recorded, Provided for, Disclosed, Ignored…
Depreciation	Straight Line Method, Reducing Balance Method, Depletion Method etc.

This list is exhaustive i.e. endless. For every item right from valuation of assets and liabilities to recognition of revenue, providing for expected losses, for each event, accountant need to form a principles and evolve a method to adopt those principles. This method of forming and applying accounting principles is known as accounting policies.

As we say that accounts is both science and art. It's a science because we have some tested accounting principles, which are applicable universally, but simultaneously the application of these principles depends on the personal ability of each accountant. Since different accountants may have different approach, we generally find that in different enterprise under same industry, different accounting policy is followed. Though ICAI along with Government is trying to reduce the number of accounting policies followed in India but still it cannot be reduced to one.

Since accounting policy adopted will have considerable effect on the financial results disclosed by the financial statement, it makes it almost difficult to compare two financial statements.

Financial statement in India includes the following:

Balance Sheet: It discloses the information regarding short term and long term solvency of the concern i.e. through balance sheet we can judge the financial status of an enterprise.

Profit & Loss Account: It reflects the net financial result of the functioning of an enterprise during the last financial year in terms of net profits or net losses.

Cash Flow Statement for Specified Enterprises: This not only gives the information for sources from where cash was acquired by the company to finance it's activities during the relevant year but also helps in determining the future cash requirements of the concern.

Notes and Schedules forming the part of the above statements: This is an inevitable part of a financial statement, since it discloses the information that is not possible to be disclosed in Profit & Loss Account or Balance Sheet and also it clarifies the points, absence of which might misguide the user of accounts.

During 1979, when ASB was established, the business environment in India was such that enterprises were reluctant to prepare accounting notes, few enterprises used to disclose the important accounting policies but the degree and method of disclosure varies considerably. Some enterprises used to disclose them as part of main financial statement, few others as a supplementary.

Therefore the main aim of this statement is not only to promote disclosure of accounting policies but also to determine that all accounting policies are disclosed at one place as main part of the financial statement.The main purpose of Accounting Standard 1, Disclosure of Accounting Policies, is to promote better understanding of financial statements by requiring disclosure of significant accounting policies in orderly manner. As explained in the preceding paragraph, such disclosures facilitate more meaningful comparison between financial statements of different enterprises for same accounting periods. The standard also requires disclosure of changes in accounting policies such that the users can compare financial statements of same enterprise for different accounting periods.

2.3 Applicability

This AS was issued in 1979 and in the initial years, it was recommendatory in character. During this period, this standard was recommended for use by companies listed on a recognised stock exchange and other large commercial, industrial and business enterprises in the public and private sectors i.e. Level I enterprises. It may be noted that the standard is now mandatory and is applicable for all enterprises.

2.4 Fundamental Accounting Assumptions

The Accounting Standard 1 recognises three fundamental accounting assumptions. These are

(a) Going Concern

(b) Consistency and

(c) Accrual.

So long as these assumptions are followed in preparation of financial statements, no disclosure of such adherence is necessary. Any departure from any of these assumptions should however be disclosed.

(a) Going Concern Assumption: The enterprise is normally viewed as a going concern, i.e. as continuing operations for the foreseeable future. It is assumed that the enterprise has neither the intention nor the necessity of liquidation or curtailing, materially its scale of operations.

Accordingly, assets and liabilities are recorded on the basis that the enterprise will be able to realise its assets and discharge its liabilities in the normal course of business. If an enterprise is not a going concern, valuation of its assets and liabilities on historical cost becomes irrelevant and as a consequence its profit/loss may not give reliable information.

For example: A Ltd. been acquired by B Ltd. during May 2006, since now B Ltd. is no more a going concern, this fact should be disclosed in the financial statement of B Ltd. for the year ended March 31, 2006.

(b) Accrual Assumption: Revenues and costs are recorded as they accrued, i.e., revenue items recognized as they are earned or incurred and recorded in the financial statements of the periods to which they relate even though payment and receipt of actual cash has not taken place. This assumption is the core of accrual accounting system.

For example: Credit sales of goods on March 01, 2010; money receivable after three months, are recognised as sales during the financial year 2009-10 itself and amount due is debited to the customer’s account. Similarly credit purchase of goods is also recorded as purchases during the year when purchase takes place and amount payable is credited to the suppliers account.

(c) Consistency Assumption: It is assumed that accounting policies are consistent from one period to another. Unless this is done, comparatives are rendered meaningless. If comparability is lost, the relevance of accounting data for users’ judgment and decision-making is gone.

For example: If enterprise has opted for written down value method of charging depreciation then in the following years, it should stick to this method, unless under changed environment it is considered highly inappropriate to continue with it.

2.5 Considerations in the Selection of Accounting Policies

The primary consideration in the selection of accounting policies by an enterprise is that the fianancial statements prepared and presented on the basis of such accounting policies should represent a true and fair view of the state of affairs of the enterprise as at the balance sheet date and of the profit or loss for the period ended on that date. To ensure the true and fair consideration this statement issues following guidelines:

Prudence: As defined in the statement, prudence means recognising all losses immediately but ignoring anticipated profits. Business environment is highly dynamic, therefore, enterprises has to keep anticipate the future and take managerial decisions accordingly. In view of the uncertainty attached to future events, profits are not anticipated but recognised only when realised though not necessarily in cash. Provision is made for all known liabilities and losses even though the amount cannot be determined with certainty and represents only a best estimate in the light of available information. For Example: If valuation of stock is always done at cost, consider a situation where market price of the relevant goods has reduced below the cost price, then valuing stock at cost price means ignoring anticipated losses. Similarly if stock is always valued at market price, then take a situation where cost price is below market price, indirectly we are recognising the anticipated gross profit on stock in the books. Therefore, accounting policy should be cost price or market price whichever is less, in this case we are ignoring anticipated profits (if any) but any anticipated losses would be taken care of.

Substance over form: The accounting treatment and presentation in financial statements of transactions and events should be governed by their substance and not merely by the legal form.

For Example: The ownership of an asset purchased on hire purchase is not transferred till the payment of the last instalment is made but the asset is shown in the books of the hire purchaser. Similarly, in the case of the amalgamation, the entry for amalgamation in the books of the amalgamated company is recorded on the basis of the status of the shareholders of amalgamating company after amalgamation i.e. if all or almost all the shareholders of the amalgamated company has become shareholder of the amalgamating company by virtue of amalgamation, we record all the transactions as Amalgamation in nature of Merger otherwise it is recorded as Amalgamation in nature of Purchase.

Materiality: Financial statements should disclose all 'material' items, ie items the knowledge of which might influence the decisions of the user of the financial statements.

The materiality of an item is decided on the basis that whether non-disclosure of the item will effect the decision making of the user of accounts. If the answer is positive then the item is material and should be disclosed, in case answer is negative, item is immaterial. By this statement does not mean that immaterial item should not be disclosed, disclosure or non-disclosure of an immaterial item is left at the discretion of the accountant but disclosure of material item is been made mandatory.

For Example, Any penalty paid by the enterprise should be disclosed separately even though the amount paid is negligible, payment of any tax also should be disclosed separately and not to be merged with office expenses or miscellaneous expense.

2.6 Disclosure of Accounting Policies

(i) To ensure proper understanding of financial statements, it is necessary that all significant accounting policies adopted in the preparation and presentation of financial statements should be disclosed.

(ii) 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.

2.7 Disclosure of Changes in Accounting Policies

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

2.8 Disclosure of Deviations from Fundamental Accounting Assumptions

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

The principle of consistency refers to the practice of using same accounting policies for similar transactions in all accounting periods. The deviation from the principle of consistency therefore means a change in accounting policy, the disclosure requirements for which are covered by paragraph 26 of the standard.

2.9 Illustrations

Illustration 1

A Ltd. has sold its building for ₹ 50 lakhs to B Ltd. and has also given the possession to B Ltd. The book value of the building is ₹ 30 lakhs. As on 31st March, 2012, the documentation and legal formalities are pending. The company has not recorded the sale and has shown the amount received as advance. Do you agree with this treatment?

Solution

The economic reality and substance of the transaction is that the rights and beneficial interest in the property has been transferred although legal title has not been transferred. A Ltd.

should record the sale and recognize the profit of ₹ 20 lakhs in its profit and loss account. The building should be eliminated from the balance sheet.

Illustration 2

ABC Ltd. was making provision for non-moving stocks based on no issues for the last 12 months up to 31.3.2011.

The company wants to provide during the year ending 31.3.2012 based on technical evaluation:

Total value of stock	*₹ 100 lakhs*
Provision required based on 12 months issue	*₹ 3.5 lakhs*
Provision required based on technical evaluation	*₹ 2.5 lakhs*

Does this amount to change in Accounting Policy? Can the company change the method of provision?

Solution

The decision of making provision for non-moving stocks on the basis of technical evaluation does not amount to change in accounting policy. Accounting policy of a company may require that provision for non-moving stocks should be made. The method of estimating the amount of provision may be changed in case a more prudent estimate can be made.

In the given case, considering the total value of stock, the change in the amount of required provision of non-moving stock from ₹ 3.5 lakhs to ₹ 2.5 lakhs is also not material. The disclosure can be made for such change in the following lines by way of notes to the accounts in the annual accounts of ABC Ltd. for the year 2011-12:

"The company has provided for non-moving stocks on the basis of technical evaluation unlike preceding years. Had the same method been followed as in the previous year, the profit for the year and the corresponding effect on the year end net assets would have been higher by ₹ 1 lakh."

Illustration 3

Jagannath Ltd. had made a rights issue of shares in 2010. In the offer document to its members, it had projected a surplus of ₹ 40 crores during the accounting year to end on 31st March, 2012. 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 ₹ 10 crores. The board in consultation with the managing director, decided on the following :

(i) Value year-end inventory at works cost (₹ 50 crores) instead of the hitherto method of valuation of inventory at prime cost (₹ 30 crores).

(ii) Provide depreciation for the year on straight line basis on account of substantial additions in gross block during the year, instead of on the reducing balance method, which was hitherto adopted. As a consequence, the charge for depreciation at ₹ 27 crores is lower than the amount of ₹ 45 crores which would have been provided had the old method been followed, by ₹ 18 cores.

(iii) Not to provide for "after sales expenses" during the warranty period. Till the last year, provision at 2% of sales used to be made under the concept of "matching of costs 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 ₹ 600 crores.

(iv) Provide for permanent fall in the value of investments - which fall had taken place over the past five years - the provision being ₹ 10 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 2011-2012.

Solution

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

Notes on Accounts:

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

(ii) In view of the heavy capital intensive method of production introduced during the year, the company has decided to change the method of providing depreciation from reducing balance method to straight line method. As a result of this change, depreciation has been provided at ₹ 27 crores which is lower than the charge which would have been made had the old method and the old rates been applied, by ₹ 18 crores. To that extent, the profit for the year is increased.

(iii) So far, the company has been providing 2% of sales for meeting "after sales expenses during the warranty period. With the improved method of production, the probability of defects occurring in the products has reduced considerably. Hence, the company has decided not to make provision for such expenses but to account for the same as and when expenses are incurred. Due to this change, the profit for the year is increased by ₹ 12 crores than would have been the case if the old policy were to continue.

(iv) The company has decided to provide ₹ 10 crores for the permanent fall in the value of investments which has taken place over the period of past five years. The provision so made has reduced the profit disclosed in the accounts by ₹ 10 crores.

UNIT 3 : AS 2 : VALUATION OF INVENTORIES

Reference: The students are advised to refer the full text of AS 2 "Valuation of Inventories" (revised 1999) given in Appendix I at the end of the Study Material (Volume-II).

3.1 Introduction

The accounting treatment for inventories is prescribed in AS 2 'Valuation of Inventories', which provides guidance for determining the value at which inventories, are carried in the financial statements until related revenues are recognised. It also provides guidance on the cost formulas that are used to assign costs to inventories and any write-down thereof to net realisable value.

This Statement does not apply in accounting for the following inventories:

(a) Work in progress arising under construction contracts, including directly related service 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 realisable value in accordance with well established practices in those industries.

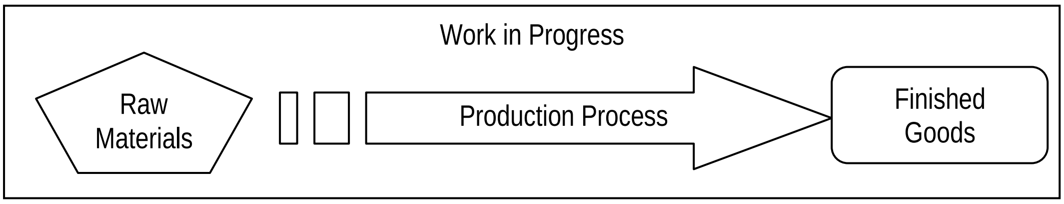
3.2 Scope

AS 2 defines inventories as assets

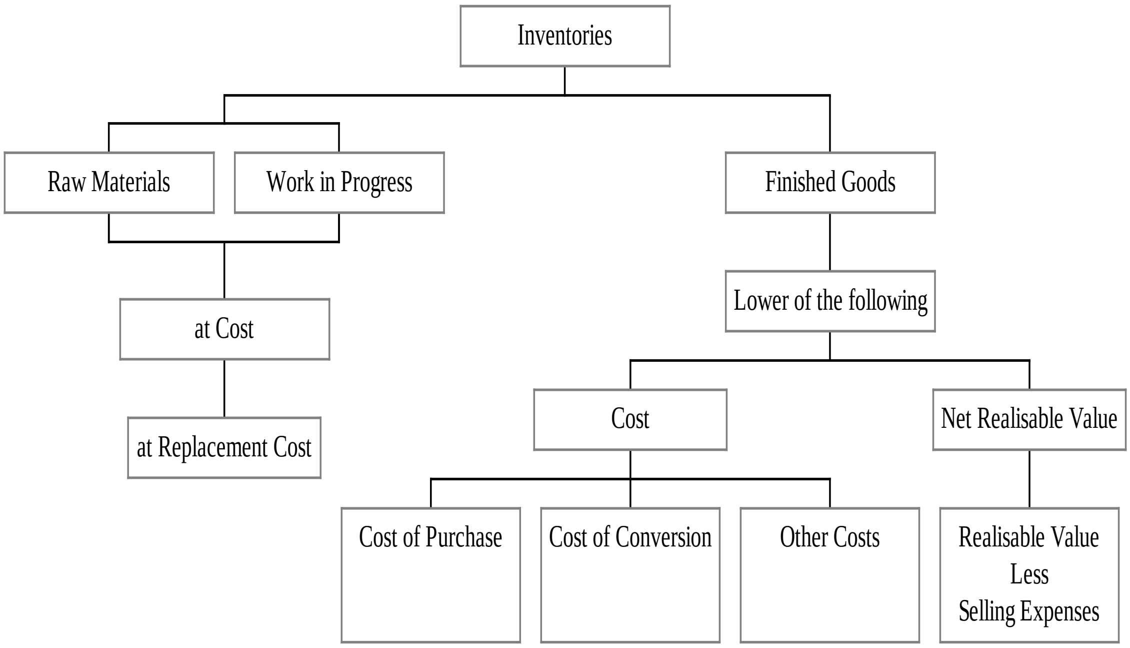
(a) Held for sale in the ordinary course of business. It means finished goods ready for sale in case of a manufacturer and for traders, goods purchased by them with the intention of resale but not yet sold. These are known as Finished Goods.

(b) In the process of production for such sale. These refer to the goods which are introduced to the production process but the production is not yet completed i.e. not fully converted into finished goods. These are known as Work-in-Progress.

(c) In the form of materials or supplies to be consumed in the production process or in the rendering of services. It refers to all the materials and spares i.e. to be consumed in the process of production. These are known as Raw Materials.



INVENTORIES



3.3 Measurement of Inventories

Inventories should be valued at the lower of cost and net realisable value.

Cost of goods is the summation of:

(a) Cost of Purchase.

(b) Cost of Conversion.

(c) Other cost necessary to bring the inventory in present location and condition.

As shown in the above diagram, finished goods should be valued at cost or market price whichever is lower, in other words, finished goods are valued at the lower of cost or net realisable value.

Cost has three elements as discussed below:

Cost of Purchase: Cost of purchase includes the purchase price plus all other necessary expenses directly attributable to purchase of stock like, taxes, duties, carriage inward, loading/unloading excluding expenses recoverable from the supplier.

From the above sum, following items are deducted, duty drawback, CENVAT, VAT, trade discount, rebates.

Cost of Conversion: For a trading company cost of purchase along with other cost (discussed below) constitutes cost of inventory, but for a manufacturer cost of inventory also includes cost of conversion. Readers can recollect the calculation of factory cost calculated in Cost Accounting:

Direct Material + Direct Labour = Prime Cost

Prime Cost + Factory Variable Overhead + Factory Fixed Overhead = Factory Cost.

Direct material is included in cost of purchase and the remaining items i.e. direct labour and overheads are termed as cost of conversion.

Direct labour is cost of workers in the unit who are directly associated with the production process, in other words we can say that direct labour is the cost of labour which can be directly attributed to the units of production.

Overheads are indirect expenses. Variable overheads are indirect expenses which is directly related to production i.e., it changes with the change in production in the same proportion (increase or decrease). Fixed overheads generally remains constant, it varies only when there is some major shift in production.

Since direct labour and variable overheads are directly with the production level, it is advisable to include them in cost of conversion on the basis of normal capacity. Because any difference between normal capacity and actual production will also bring in proportionate change in projected cost and actual cost.

For example: A unit is expected to produce 1 lacs units in a year with the projected labour cost ₹ 20 lacs and variable overhead ₹ 10 lacs. But the actual cost was only ₹ 18 lacs labour charges and ₹ 9 lacs overheads with production only 90,000 units. Now if we take these costs on normal capacity basis then direct labour is ₹ 20 per unit (20 lacs/1 lac) and variable overhead is ₹ 10 per unit (10 lacs/1 lac). Therefore in cost of conversion we include direct labour (90,000 x 20) ₹ 18 lacs and variable overheads (90,000 x 10) ₹ 9 lacs.

Fixed overheads are taken on the basis of normal capacity when actual production is equal to normal capacity or the difference is minor. In case when actual production increases normal capacity considerably, fixed overheads are included on the basis of actual capacity. When actual production is substancially less than normal capacity, fixed overhead is included on the basis of normal capacity. To understand the reason for such a provision we take an example:

ABC Ltd. has a plant with the capacity to produce 1 lac unit of a product per annum and the expected fixed overhead is ₹ 18 lacs. Fixed overhead on the basis of normal capacity is ₹ 18 (18 lacs/1 lac).

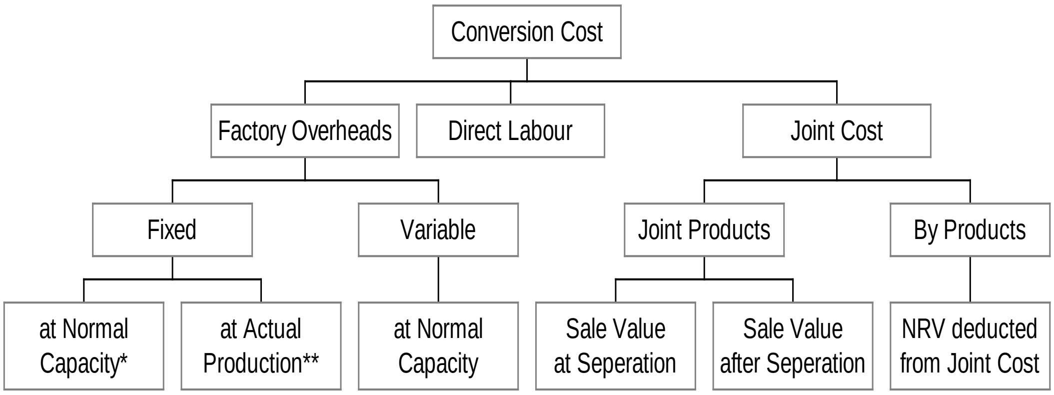
Case 1: Actual production is 1 lac units. Fixed overhead on the basis of normal capacity and actual overhead will lead to same figure of ₹ 18 lacs. Therefore it is advisable to include this on normal capacity.

Case 2: Actual production is 90,000 units. Fixed overhead is not going to change with the change in output and will remain constant at ₹ 18 lacs, therefore, overheads on actual basis is ₹ 20 (18 lacs/ 90 thousands). Hence by valuing stock at ₹ 20 each for fixed overhead purpose, it will be overvalued and the losses of ₹ 1.8 lacs will also be included in closing stock leading to a higher gross profit then actually earned. Therefore, it is advisable to include fixed overhead on normal capacity (90,000 x 18) ₹ 16.2 lacs and rest ₹ 1.2 lacs will be transferred to Profit & Loss Account.

Case 3: Actual production is 1.2 lacs units. Fixed overhead is not going to change with the change in output and will remain constant at ₹ 18 lacs, therefore, overheads on actual basis is

₹ 15 (18 lacs/ 1.2 lacs). Hence by valuing stock at ₹ 18 each for fixed overhead purpose, we will be adding the element of cost to inventory which actually has not been incurred. At ₹ 18 total overhead will come to ₹ 21.6 lacs whereas actual overhead expense is only ₹ 18 lacs. Therefore, it is advisable to include fixed overhead on actual basis (1.2 lacs x 15) ₹ 18 lacs.

Sometimes, a single production process may result in more than one product. In case, this additional product is the intended and has a good market value, they are known as joint products. The cost of conversion incurred on all the production and not identifiable separately is allocated among the products on some rational and consistent basis. If this additional product don't have good market value then they are considered as by-products. In this case the net realisable value of the by-products are deducted from the total cost of conversion to calculate the cost of conversion for main product.



* When actual production is almost equal or lower than normal capacity.

** When actual production is higher than normal capacity.

Other Costs: Other costs are included in the cost of inventories only to the extent that they are incurred in bringing the inventories to their present location and condition. For example, it may be appropriate to include overheads other than production overheads or the costs of designing products for specific customers in the cost of inventories.

AS 2 gives the following as examples of costs that should be excluded from the cost of inventories and recognised as expenses in the period in which they are incurred:

(a) Abnormal amounts of wasted materials, labour, or other production costs.

(b) Storage costs, unless those costs are necessary in the production process prior to a further production stage.

(c) Administrative overheads that do not contribute to bringing the inventories to their present location and condition and

(d) Selling and distribution costs.

Illustration 1

A ltd. purchased 1,00,000 MT for ₹ 100 each MT of raw material and introduced in the production process to get 85,000 MT as output. Normal wastage is 5%. In the process, company incurred the following expenses:

Direct Labour	*₹ 10,00,000*
Direct Variable Overheads	*₹ 1,00,000*
Direct Fixed Overheads	*₹ 1,00,000*
(Including interest ₹ 40,625)	

Of the above 80,000 MT was sold during the year and remaining 5,000 MT remained in closing stock. Due to fall in demand in market the selling price for the finished goods on the closing day was estimated to be ₹ 105 per MT. Calculate the value of closing stock.

Solution:

Calculation of cost for closing stock

Particulars	₹
Cost of Purchase (1,00,000 x 100)	1,00,00,000
Direct Labour	10,00,000
Variable Overhead	1,00,000
Fixed Overhead $\frac{(1{,}00{,}000 - 40{,}625) \times 85{,}000}{95{,}000}$	53,125
Cost of Production	1,11,53,125
Cost of closing stock per unit (1,11,53,125/85,000)	₹ 131 (approx)
Net Realisable Value per unit	₹ 105

Since net realisable value is less than cost, closing stock will be valued at ₹ 105. Therefore closing stock is ₹ 5,25,000 (5,000 x 105).

Borrowing Costs

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.

There may, however, be few exceptions to the above rule. As per AS 16, borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset are capitalised as part of the cost of the qualifying asset. Accordingly, inventories that necessarily take a substantial period of time to bring them to a saleable condition are qualifying assets.

As per AS 16, for inventories that are qualifying assets, any directly attributable borrowing costs should be capitalised as part of their cost.

3.4 Cost Formulas

Following are the various cost formulae suggested by the statement:

Specific Identification Method: It is suitable for the inventories where each unit of stock along with their associated cost can be separately identified. In other words, it is suitable where one unit of stock is not interchangeable with another unit. Under this method each unit is valued specifically on its original cost. Examples for such goods are ship building, machinery building…

The specific identification method is not appropriate for the routine production of inventories that are ordinarily interchangeable, since, in such circumstances, an enterprise could obtain predetermined effects on the net profit or loss for the period by selecting a particular method of ascertaining the items that remain in inventories.

For items where are interchangeable, most appropriate method of cost valuation is either of the following two:

FIFO (First In First Out): It is assumed under this method that whatever is received first is issued first, which means, the stock left over belongs to the latest purchases. Closing stock is valued at the rates for the equivalent units purchased at last. During inflation stock is valued at higher price and during decrease in price, stock is valued at lower price.

Weighted Average Price: Under this method of stock valuation, to determine the cost per unit, total cost of production during the year is divided by total units. In other words, for price per unit of the closing stock we take the average price of the total goods purchased or produced during the year.

Following are cost formulae or techniques of measurement of cost suggested by AS for some special cases:

Standard Cost Method: Inventories are valued on the basis of the set standards, which are realistic and reviewed regularly and where necessary, revised in the light of the current conditions. Standard costs take into account normal levels of consumption of materials and supplies, labour, efficiency and capacity utilisation.

Adjusted Selling Price Method or Retail Method: It is recommended for retail business or in the business where the inventory comprises of many items, the individual costs of which are not readily ascertainable. All the inventories are valued at the selling price, which is then adjusted with normal gross profit ratio and selling expenses to reach at its cost.

Illustration 2

Ambica Stores is a departmental store, which sell goods on retail basis. It makes a gross profit of 20% on net sales. The following figures for the year-end are available:

Opening Stock ₹ 50,000; Purchases ₹ 3,60,000; Purchase Returns ₹ 10,000; Freight Inwards ₹ 10,000; Gross Sales ₹ 4,50,000; Sales Returns ₹ 11,250; Carriage Outwards ₹ 5,000.

Compute the estimated cost of the inventory on the closing date.

Solution:

Calculation of cost for closing stock

Particulars	₹
Opening Stock	50,000
Purchases less returns (₹ 3,60,000 – ₹ 10,000)	3,50,000
Freight Inwards	10,000
	4,10,000
Less: Net Sales (₹ 4,50,000 – ₹ 11,250)	(4,38,750)
	(28,750)
Add: Gross Profits (₹ 4,38,750 x 20%)	87,750
Closing Stock	59,000

3.5 Net Realisable Value (NRV)

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.

When we say that stock should be valued at the lower of cost or net realisable value, one should note that only under two circumstances cost of inventories will surpass its net realisable value:

1. The goods are damaged or obsolete and not expected to realise the normal sale price.
2. The cost necessary for the production of goods has gone up by greater degree.

Both the above cases we don't expect in the normal functioning of the business, hence whenever it is found that goods are valued at NRV, care should be taken to study the existing market position for the relevant products.

NRV of the goods are estimated on item to item basis and only items of the same characteristics are grouped together. Such estimation is made at the time of finalisation of accounts and circumstances existing on the date of balance sheet evident from the events after the balance sheet confirming the estimation should be taken into consideration. And assessment is made on each balance sheet date of such estimation.

While estimating the NRV, the purpose of holding the stock should also be taken into consideration. For example, the net realisable 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 than the inventory quantities held, the net realisable value of the excess inventory is based on general selling prices. Contingent losses on firm sales contracts in excess of inventory quantities held and contingent losses on firm purchase contracts are dealt with in accordance with the principles enunciated in AS 4, Contingencies and Events Occurring After the Balance Sheet Date.

For example, concern has 10,000 units in stock, of which 6,000 is to be delivered for ₹ 40 each as per a contract with one of the customer. Cost of stock is ₹ 45 and NRV estimated to be ₹ 50. In this case 6,000 units will be valued @ ₹ 40 each and rest 4,000 units will be valued @ ₹ 45 each.

This provision of cost or NRV whichever is less, is applicable only those goods which are ready for sale i.e. finished goods. Since raw materials and work in progress are not available for sale, they don't have any realisable value and therefore NRV can never be estimated. For these goods statement suggests that these should always be valued at cost. Only exception is the case when the net realisable value of the relevant finished goods is higher than cost, in this case, the relevant raw materials and work in progress should be valued at replacement cost.

Illustration 3

Particulars		*Kg.*	*₹*
Opening Stock:	Finished Goods	1,000	25,000
	Raw Materials	1,100	11,000
Purchases		10,000	1,00,000
Labour			76,500
Overheads (Fixed)			75,000
Sales		10,000	2,80,000
Closing Stock:	Raw Materials	900	
	Finished Goods	1200	

The expected production for the year was 15,000 kg of the finished product. Due to fall in market demand the sales price for the finished goods was ₹ 20 per kg and the replacement cost for the raw material was ₹ 9.50 per kg on the closing day. You are required to calculate the closing stock as on that date.

Solution

Calculation of cost for closing stock

Particulars	₹
Cost of Purchase (10,200 x 10)	1,02,000
Direct Labour	76,500
Fixed Overhead $\frac{75,000 \times 10,200}{15,000}$	51,000
Cost of Production	2,29,500
Cost of closing stock per unit (2,29,500/10,200)	₹ 22.50
Net Realisable Value per unit	₹ 20.00

Since net realisable value is less than cost, closing stock will be valued at ₹ 20.

As NRV of the finished goods is less than its cost, relevant raw materials will be valued at replacement cost i.e. ₹ 9.50.

Therefore, value of closing stock: Finished Goods (1,200 x 20)	₹ 24,000
Raw Materials (900 x 9.50)	₹ 8,550
	₹ 32,550

3.6 Disclosure

The financial statements should disclose:

(a) The accounting policies adopted in measuring inventories, including the cost formula used; and

(b) The total carrying amount of inventories together with a classification appropriate to the enterprise.

Information about the carrying amounts held in different classifications of inventories and the extent of the changes in these assets is useful to financial statement users. Common classifications of inventories are

(1) raw materials and components,

(2) work in progress,

(3) finished goods, stores and spares,

(4) and loose tools.

Illustration 4

The closing inventory at cost of a company amounted to ₹ 2,84,700. The following items were included at cost in the total:

(a) 400 coats, which had cost ₹ 80 each and normally sold for ₹ 150 each. Owing to a defect in manufacture, they were all sold after the balance sheet date at 50% of their normal price. Selling expenses amounted to 5% of the proceeds.

(b) 800 skirts, which had cost ₹ 20 each. These too were found to be defective. Remedial work in April cost ₹ 5 per skirt, and selling expenses for the batch totaled ₹ 800. They were sold for ₹ 28 each.

What should the inventory value be according to AS 2 after considering the above items?

Solution

Valuation of Closing Stock

Particulars	₹	₹
Closing Stock at cost		2,84,700
Less :Cost of 400 coats (400 x 80)	32,000	
Less: Net Realisable Value (400 x 75) – 5%	28,500	3,500
Value of Closing Stock		2,81,200

3.7 Illustrations

Illustration 5

State with reference to accounting standard, how will you value the inventories in the following cases:

(i) *Raw material was purchased at ₹ 100 per kilo. Price of raw material is on the decline. The finished goods in which the raw material is incorporated is expected to be sold at below cost. 10,000 kgs. of raw material is on stock at the year end. Replacement cost is ₹ 80 per kg.*

(ii) *In a production process, normal waste is 5% of input. 5,000 MT of input were put in process resulting in a wastage of 300 MT. Cost per MT of input is ₹ 1,000. The entire quantity of waste is on stock at the year end.*

(iii) *Per kg. of finished goods consisted of:*

Material cost	*₹ 100 per kg*
Direct labour cost	*₹ 20 per kg.*
Direct variable production overhead	*₹ 10 per kg.*

Fixed production charges for the year on normal capacity of one lakh kgs. is ₹ 10 lakhs. 2,000 kgs. of finished goods are on stock at the year end.

Solution

(a) (i) As per para 24 of AS 2 (Revised) on 'Valuation of Inventories', materials and other supplies held for use in the production of inventories are not written down below cost if the finished product 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 realisable value, the materials are written down to net realisable value. In such circumstances, the replacement cost of the materials may be the best available measure of their net realisable value.

Hence, in the given case, the stock of 10,000 kgs of raw material will be valued at ₹ 80 per kg. The finished goods, if on stock, should be valued at cost or net realisable value whichever is lower.

(ii) As per para 13 of AS 2 (Revised), abnormal amounts of waste materials, labour or other production costs are excluded from cost of inventories and such costs are recognised as expenses in the period in which they are incurred.

In this case, normal waste is 250 MT and abnormal waste is 50 MT.

The cost of 250 MT will be included in determining the cost of inventories (finished goods) at the year end. The cost of abnormal waste amounting to ₹ 50,000 (50 MT x ₹ 1,000) will be charged in the profit and loss statement.

(iii) In accordance with paras 8 and 9 of AS 2 (Revised), the costs of conversion include a systematic allocation of fixed and variable production overheads that are incurred in converting materials into finished goods. The allocation of fixed production overheads for the purpose of their inclusion in the costs of conversion is based on the normal capacity of the production facilities.

Thus, cost per kg. of finished goods can be computed as follows:

	₹.
Material cost	100
Direct labour cost	20
Direct variable production overhead	10
Fixed production overhead $\left(\frac{₹\ 10,00,000}{1,00,000}\right)$	10
	<u>140</u>

Thus, the value of 2,000 kgs. of finished goods on stock at the year end will be ₹ 2,80,000 (2,000 kgs. x ₹ 140).

Illustration 6

The company deals in three products, A, B and C, which are neither similar nor interchangeable. At the time of closing of its account for the year 2011-12. The Historical Cost and Net Realizable Value of the items of closing stock are determined as follows:

Items	*Historical Cost (₹ in lakhs)*	*Net Realisable Value (₹ in lakhs)*
A	*40*	*28*
B	*32*	*32*
C	*16*	*24*

What will be the value of Closing Stock?

Solution:

As per para 5 of AS 2 on Valuation of Inventories, inventories should be valued at the lower of cost and net realizable value. Inventories should be written down to net realizable value on an item-by-item basis in the given case.

Items	*Historical Cost (₹ in lakhs)*	*Net Realisable Value (₹ in lakhs)*	*Valuation of closing stock (₹ in lakhs)*
A	40	28	28
B	32	32	32
C	<u>16</u>	<u>24</u>	<u>16</u>
	<u>88</u>	<u>84</u>	<u>76</u>

Hence, closing stock will be valued at ₹ 76 lakhs.

UNIT 4 : AS 3 : CASH FLOW STATEMENTS

Reference: The students are advised to refer the full text of AS 3 "Cash Flow Statements" (revised 1997) given in Appendix I at the end of the Study Material (Volume-II).

4.1 Introduction

This statement comes into effect in respect of accounting periods commencing on or after 1-4-1997. This Standard supersedes Accounting Standard (AS) 3, 'Changes in Financial Position', issued in June 1981. This Standard is mandatory in nature in respect of accounting periods commencing on or after 1-4-2004 for the enterprises, which fall in the category of level I, at any time during the accounting period. 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 suppose to disclose the figures for the corresponding previous years. Whereas, if an enterprises qualifies under this statement to prepare the cash flow statements during the previous year but now disqualified, will continue to prepare cash flow statements for another two consecutive years.

4.2 Objective

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

- To identify the historical changes in the flow of cash & cash equivalents.
- To determine the future requirement of cash & cash equivalents.
- To assess the ability to generate cash & cash equivalents.
- To estimate the further requirement of generating cash & cash equivalents.
- To compare the operational efficiency of different enterprises.
- To study the insolvency and liquidity position of an enterprise.

Cash comprises cash on hand and demand deposits with banks.

Cash equivalents are:

- Short term (maximum three months of maturity from the date of acquisition),
- Highly liquid investments,
- Readily convertible,
- Convertible amounts of cash is known,
- Subject to an insignificant risk of changes in value.

For example, Share Capital is not considered as cash equivalent even though they are readily convertible into cash because, the amount that will be realized on sale of investment is not determinable unless investment is actually sold. Similarly, fixed deposit for one year is also not considered as cash equivalent because they are not readily convertible into cash, even though the amount is determinable.

One should not be confused with the concept of three months or less. As this standard states very clearly that three months or less from the date of acquisition, any investment which is not classified as cash equivalent cannot be reclassified as cash equivalent, even when the maturity period is less than three months. We should look at the status only on the date of acquisition and not later.

Cash flows are inflows and outflows of cash and cash equivalents.

4.3 Presentation of a Cash Flow Statement

AS 3 'Cash Flow Statements' requires the presentation of information about the historical changes in the cash and cash equivalents of an enterprise in the relevant accounting year by means of a cash flow statement, which classifies cash flows during the period according to operating, investing and financing activities.

Operating activities are the principal revenue-producing activities of the enterprise and other activities that are not investing or financing activities.

Examples of cash flows from operating activities are:

- cash received in the year from customers (in respect of sale of goods or services rendered either in the year, or in an earlier year, or received in advance in respect or the sale of goods or services to be rendered in a later year);
- cash payments in the year to suppliers (for raw materials or goods for resale whether supplied in the current year, or an earlier year, or to be supplied in a later year);
- the payment of wages and salaries to employees;
- tax and other payments on behalf of employees;
- the payment of rent on property used in the business operations; royalties received in the year;
- cash receipts and cash payments of an insurance enterprise for premiums and claims, annuities and other policy benefits;
- the payment of insurance premiums;
- cash payments or refunds of income taxes that cannot be specifically identified with financing or investing activities
- cash flows arising from futures contracts, forward contracts, option contracts or swap contracts hedging a transaction that is itself classified as operating; and
- cash flows arising from the purchase and sale of securities and loans held for dealing or trading purposes.

Investing activities are the acquisition and disposal of long-term assets and other investments not included in cash equivalents.

Examples of cash flows arising from investing activities include:

- cash payment to acquire fixed assets (including intangibles). These payments include those relating to capitalised research and development costs and self-constructed fixed assets;
- cash receipts from disposal of fixed assets (including intangibles);
- cash payments to acquire shares, warrants or debt instruments of other enterprises and interests in joint ventures (other than payments for those instruments considered to be cash equivalents and those held for dealing or trading purposes);
- cash receipts from disposal of shares, warrants or debt instruments of other enterprises and interests in joint ventures (other than receipts for those instruments considered to be cash equivalents and those held for dealing or trading purposes);
- cash advances and loans made to third parties (other than advances and loans made by a financial enterprise);
- cash receipts from the repayment of advances and loans made to third parties (other than advances and loans of a financial enterprise);
- cash payments for futures contracts, forward contracts, option contracts and swap contracts except when the contracts are held for dealing or trading purposes, or the payments are classified as financing activities; and
- cash receipts from futures contracts, forward contracts, option contracts and swap contracts, except when the contracts are held for dealing or trading purposes or the receipts are classified as financing activities.

.*Financing activities* are activities that result in changes in the size and composition of the owners' capital (including preference share capital in the case of a company) and borrowings of the enterprise.

Examples of cash flows arising from financing activities are:

- cash proceeds from issuing shares or other similar instruments;
- cash proceeds from issuing debentures, loans, notes, bonds, and other short or long-term borrowings; and
- cash repayments of amounts borrowed.

So all the transactions should be classified under each of these heads and presented in CFS, this kind of presentation gives a very clear idea to the users regarding the major sources of cash inflows, from where all the activities are financed by the enterprises. Say if net cash flow from operating activities is negative and net cash flow from investing activities is positive, this does not potrait a good picture of the functioning of the enterprise. Sometimes, A single transaction may include cash flows that are classified differently. For example, when the instalment paid in respect of a fixed asset acquired on deferred payment basis includes both interest and loan, the interest element is classified under financing activities and the loan element is classified under investing activities.

Illustration 1

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

a. Purchase of Machinery.

b. Proceeds from issuance of equity share capital

c. Cash Sales.

d. Proceeds from long-term borrowings.

e. Proceeds from Debtors.

f. Cash receipts from Debtors.

g. Trading Commission received.

h. Purchase of investment.

i. Redemption of Preference Shares.

j. Cash Purchases.

k. Proceeds from sale of investment

l. Purchase of goodwill.

m. Cash paid to suppliers.

n. Interim Dividend paid on equity shares.

o. Wages and salaries paid.

p. Proceed from sale of patents.

q. Interest received on debentures held as investment.

r. Interest paid on Long-term borrowings.

s. Office and Administration Expenses paid

t. Manufacturing Overheads paid.

u. Dividend received on shares held as investments.

v. Rent Received on property held as investment.

w. Selling and distribution expense paid.

x. Income tax paid

y. Dividend paid on Preference shares.

z. Underwritings Commission paid.

aa. Rent paid.

bb. Brokerage paid on purchase of investments.

cc. Bank Overdraft

dd. Cash Credit

ee. Short-term Deposits

ff. Marketable Securities

gg. Refund of Income Tax received.

Solution

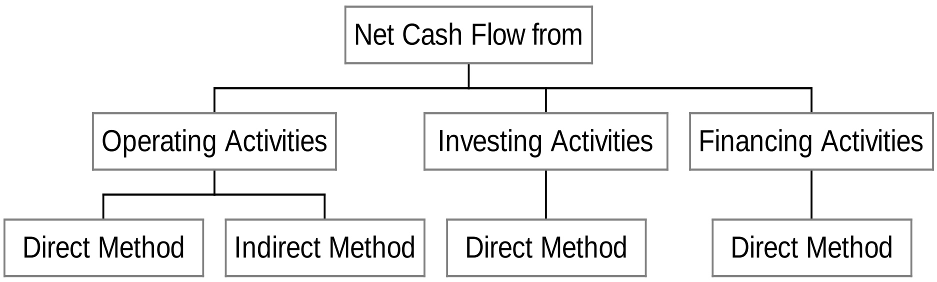
Operating Activities: c, e, f, g, j, m, o, s, t, w, x, aa & gg.

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

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

Cash Equivalent: ff.

Cash Flow during the Year is



Operating Activities

As discussed earlier, operating activities are those activities which determines the profit/loss result of the enterprise, hence this head helps us to determine that whether the concern has sufficient cash inflow from their normal operations to support their operating cash outflow, and also the other cash outflow.

There are few items extraordinary items, which are recorded in Profit and Loss Account, but are not to be classified as operating activity, such as, profit/loss on sale of fixed asset. Fixed assets are to be classified as investing activities, therefore any sale proceeds from such items will go to investing activities. If investments are held as stock in trade, in such a case we will disclose them as operating activities.

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

In 'Direct method' we take the gross receipts from sales, debtors and other operating inflows subtracted by gross payments for purchases, creditors and other expenses ignoring all non-cash items like depreciation, provisions. In 'Indirect method' we start from the net profit or loss figure, eliminate the effect of any non cash items, investing items and financing items from such profit figure i.e. all such expenses like depreciation, provisions, interest paid, loss on sale of assets etc. are added and interest received etc. are deducted. Adjustment for changes in working capital items are also made ignoring cash and cash equivalent to reach to the figure of net cash flow.

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

Below is the format for Cash Flow Statement

Cash Flow Statement of X Ltd. for the year ended March 31, 20xx (Direct Method)

Particulars	₹	₹
Operating Activities:		
Cash received from sale of goods	xxx	
Cash received from Debtors	xxx	
Cash received from sale of services	xxx	xxx
Less: Payment for Cash Purchases	xxx	
Payment to Creditors	xxx	
Payment for Operating Expenses	xxx	
e.g. power, rent, electricity…		
Payment for wages & Salaries	xxx	
Payment for Income Tax	xxx	xxx
		xxx
Adjustment for Extraordinary Items		xxx
Net Cash Flow from Operating Activities		xxx

Cash Flow Statement of X Ltd. for the year ended March 31, 20xx (Indirect Method)

Particulars	₹.	₹
Operating Activities:		
Closing balance of Profit & Loss Account	xxx	
Less: Opening balance of Profit & Loss Account	xxx	
	xxx	
Reversal the effects of Profit & Loss Appropriation Account	xxx	
Add: Provision for Income Tax	xxx	
Effects of Extraordinary Items	xxx	
Net Profit Before Tax and Extraordinary Items	xxx	
Reversal the effects of non-cash and non-operating items	xxx	

Effects for changes in Working Capital except cash & cash equivalent	xxx	
	xxx	
Les : Payment of Income Tax	xxx	xxx
Adjustment for Extraordinary Items		xxx
Net Cash Flow from Operating Activities		xxx

Illustration 2

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

Summary of Cash Account
for the year ended March 31, 2012

Particulars	₹	*Particulars*	₹.
To Balance b/d	*1,00,000*	*By Cash Purchases*	*1,20,000*
To Cash sales	*1,40,000*	*By Creditors*	*1,57,000*
To Debtors	*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*

Solution

Cash Flow Statement of ……
for the year ended March 3, 2012 (Direct Method)

Particulars	₹.	₹.
Operating Activities:		
Cash received from sale of goods	1,40,000	
Cash received from Debtors	1,75,000	
Trade Commission received	50,000	3,65,000
Less: Payment for Cash Purchases	1,20,000	
Payment to Creditors	1,57,000	
Office and Selling Expenses	75,000	
Payment for Income Tax	30,000	(3,82,000)
Net Cash Flow from Operating Activities		(17,000)

Illustration 3

Ms. Jyoti of Star Oils Limited has collected the following information for the preparation of cash flow statement for the year 2011 :

	(₹ 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*
Amortisation of Capital grant	*6*
Profit on sale of Investments	*100*
Carrying amount of Investment sold	*27,765*
Interest income on investments	*2,506*
Increase expenses	*10,000*
Interest paid during the year	*10,520*
Increase in Working Capital (excluding Cash & Bank Balance)	*56,075*
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*
Required :	

Prepare the Cash Flow Statement for the year 2011 in accordance with AS 3, Cash Flow Statements issued by the Institute of Chartered Accountants of India.

Solution

Star Oils Limited
Cash Flow Statement
for the year ended 31st December, 2011

	(₹ in lakhs)
Cash flows from operating activities	
Net profit before taxation (25,000 + 5,000)	30,000
Adjustments for :	
Depreciation	20,000
Loss on sale of assets (Net)	40
Amortisation of capital grant	(6)
Profit on sale of investments	(100)
Interest income on investments	(2,506)
Interest expenses	10,000
Operating profit before working capital changes	57,428
Changes in working capital (Excluding cash and bank balance)	(56,075)
Cash generated from operations	1,353
Income taxes paid	(4,248)
Net cash used in operating activities	(2,895)
Cash flows from investing activities	
Sale of assets	145
Sale of investments (27,765 + 100)	27,865
Interest income on investments	2,506
Purchase of fixed assets	(14,560)
Investment in joint venture	(3,850)
Expenditure on construction work-in progress	(34,740)
Net cash used in investing activities	(22,634)
Cash flows from financing activities	
Proceeds from calls in arrear	2
Receipts of grant for capital projects	12
Proceeds from long-term borrowings	25,980
Proceed from short-term borrowings	20,575
Interest paid	(10,520)
Dividend (including dividend tax) paid	(8,535)
	27,514
Net increase in cash and cash equivalents	1,985
Cash and cash equivalents at the beginning of the period	5,003
Cash and cash equivalents at the end of the period	6,988

Working Note :

	(₹) in lakh
Book value of the assets sold	185
Less : Loss on sale of assets	(40)
Proceeds on sale	145

Assumption :

Interest income on investments ₹ 2,506 has been received during the year.

Illustration 4

From the following Summary Cash Account of X Ltd. prepare Cash Flow Statement for the year ended 31st March, 2012 in accordance with AS 3 (Revised) using the direct method. The company does not have any cash equivalents.

Summary Cash Account for the year ended 31.3.2012

	₹ '000		*₹ '000*
Balance on 1.4.2011	*50*	*Payment to Suppliers*	*2,000*
Issue of Equity Shares	*300*	*Purchase of Fixed Assets*	*200*
Receipts from Customers	*2,800*	*Overhead expense*	*200*
Sale of Fixed Assets	*100*	*Wages and Salaries*	*100*
		Taxation	*250*
		Dividend	*50*
		Repayment of Bank Loan	*300*
		Balance on 31.3.2012	*150*
	3,250		*3,250*

Solution

X Ltd.

Cash Flow Statement for the year ended 31st March, 2012

(Using the direct method)

	₹ '000	*₹000*
Cash flows from operating activities		
Cash receipts from customers	2,800	
Cash payments to suppliers	(2,000)	
Cash paid to employees	(100)	
Cash payments for overheads	(200)	
Cash generated from operations	500	
Income tax paid	(250)	
Net cash from operating activities		250

Cash flows from investing activities		
Payments for purchase of fixed assets	(200)	
Proceeds from sale of fixed assets	100	
Net cash used in investing activities		(100)
Cash flows from financing activities		
Proceeds from issuance of equity shares	300	
Bank loan repaid	(300)	
Dividend paid	(50)	
Net cash used in financing activities		(50)
Net increase in cash		100
Cash at beginning of the period		50
Cash at end of the period		150

Illustration 5

The Balance Sheet of New Light Ltd. for the years ended 31st March, 2011 and 2012 are as follows:

Liabilities	*31st March 2011 (₹)*	*31st March 2012 (₹)*	*Assets*	*31st March 2011 (₹)*	*31st March 2012 (₹)*
Equity share capital	*12,00,000*	*16,00,000*	*Fixed Assets*	*32,00,000*	*38,00,000*
10% Preference share capital	*4,00,000*	*2,80,000*	*Less: Depreciation*	*9,20,000*	*11,60,000*
				22,80,000	*26,40,000*
Capital Reserve	*–*	*40,000*	*Investment*	*4,00,000*	*3,20,000*
General Reserve	*6,80,000*	*8,00,000*	*Cash*	*10,000*	*10,000*
Profit and Loss A/c	*2,40,000*	*3,00,000*	*Other current assets*	*11,10,000*	*13,10,000*
9% Debentures	*4,00,000*	*2,80,000*	*Preliminary expenses*	*80,000*	*40,000*
Current liabilities	*4,80,000*	*5,20,000*			
Proposed dividend	*1,20,000*	*1,44,000*			
Provision for Tax	*3,60,000*	*3,40,000*			
Unpaid dividend	*–*	*16,000*			
	38,80,000	*43,20,000*		*38,80,000*	*43,20,000*

Additional information:

(i) The company sold one fixed asset for ₹ 1,00,000, the cost of which was ₹ 2,00,000 and the depreciation provided on it was ₹ 80,000.

(ii) The company also decided to write off another fixed asset costing ₹ 56,000 on which depreciation amounting to ₹ 40,000 has been provided.

(iii) Depreciation on fixed assets provided ₹ 3,60,000.

(iv) Company sold some investment at a profit of ₹ 40,000, which was credited to capital reserve.

(v) Debentures and preference share capital redeemed at 5% premium.

(vi) Company decided to value stock at cost, whereas previously the practice was to value stock at cost less 10%. The stock according to books on 31.3.2011 was ₹ 2,16,000. The stock on 31.3.2012 was correctly valued at ₹ 3,00,000.

Prepare Cash Flow Statement as per revised AS 3 by indirect method.

Solution

New Light Ltd.

Cash Flow Statement for the year ended 31st March, 2012

		₹	₹
A.	Cash Flow from operating activities		
	Profit after appropriation		
	Increase in profit and loss A/c after inventory adjustment [₹ 3,00,000 – (₹ 2,40,000 + ₹ 24,000)]	36,000	
	Transfer to general reserve	1,20,000	
	Proposed dividend	1,44,000	
	Provision for tax	3,40,000	
	Net profit before taxation and extraordinary item	6,40,000	
	Adjustments for:		
	Preliminary expenses written off	40,000	
	Depreciation	3,60,000	
	Loss on sale of fixed assets	20,000	
	Decrease in value of fixed assets	16,000	
	Premium on redemption of preference share capital	6,000	
	Premium on redemption of debentures	6,000	
	Operating profit before working capital changes	10,88,000	
	Increase in current liabilities (₹ 5,20,000 –₹ 4,80,000)	40,000	
	Increase in other current assets [₹ 13,10,000 – (₹ 11,10,000 + ₹ 24,000)]	(1,76,000)	
	Cash generated from operations	9,52,000	
	Income taxes paid	(3,60,000)	
	Net Cash from operating activities		5,92,000

B.	Cash Flow from investing activities		
	Purchase of fixed assets	(8,56,000)	
	Proceeds from sale of fixed assets	1,00,000	
	Proceeds from sale of investments	1,20,000	
	Net Cash from investing activities		(6,36,000)
C.	Cash Flow from financing activities		
	Proceeds from issuance of share capital	4,00,000	
	Redemption of preference share capital (₹1,20,000 + ₹ 6,000)	(1,26,000)	
	Redemption of debentures (₹ 1,20,000 + ₹ 6,000)	(1,26,000)	
	Dividend paid	(1,04,000)	
	Net Cash from financing activities		44,000
	Net increase/decrease in cash and cash equivalent during the year		Nil
	Cash and cash equivalent at the beginning of the year		10,000
	Cash and cash equivalent at the end of the year		10,000

Working Notes:

1. Revaluation of stock will increase opening stock by ₹ 24,000.

$$\frac{2,16,000}{90} \times 10 = ₹\ 24,000$$

Therefore, opening balance of other current assets would be as follows:

₹ 11,10,000 + ₹ 24,000 = ₹ 11,34,000

Due to under valuation of stock, the opening balance of profit and loss account be increased by ₹ 24,000.

The opening balance of profit and loss account after revaluation of stock will be

₹ 2,40,000 + ₹ 24,000 = ₹ 2,64,000

2. Investment Account

		₹			₹
To	Balance b/d	4,00,000	By	Bank A/c (balancing figure being investment sold)	1,20,000
To	Capital reserve A/c (Profit on sale of investment)	40,000	By	Balance c/d	3,20,000
		4,40,000			4,40,000

3. Fixed Assets Account

		₹			₹	₹
To	Balance b/d	32,00,000	By	Bank A/c (sale of assets)	1,00,000	
To	Bank A/c (balancing figure being assets purchased)	8,56,000	By	Accumulated depreciation A/c	80,000	
			By	Profit and loss A/c (loss on sale of assets)	20,000	2,00,000
			By	Accumulated depreciation A/c	40,000	
			By	Profit and loss A/c (assets written off)	16,000	56,000
			By	Balance c/d		38,00,000
		40,56,000				40,56,000

4. Accumulated Depreciation Account

		₹			₹
To	Fixed assets A/c	80,000	By	Balance b/d	9,20,000
To	Fixed assets A/c	40,000	By	Profit and loss A/c (depreciation for the period)	3,60,000
To	Balance c/d	11,60,000			
		12,80,000			12,80,000

5. Unpaid dividend is taken as non-current item and dividend paid is shown at ₹ 1,04,000 (₹ 1,20,000 – ₹ 16,000).

Note: Alternatively, unpaid dividend can be assumed as current liability and hence, dividend paid can be shown at ₹ 1,20,000. Due to this assumption cash flow from operating activities would be affected. The cash flow from operating activities will increase by ₹ 16,000 to ₹ 6,08,000 and cash flow from financing activities will get reduced by ₹ 16,000 to ₹ 28,000.

UNIT 5 : AS 4: CONTINGENCIES AND EVENTS OCCURRING AFTER THE BALANCE SHEET DATE

Reference: The students are advised to refer the full text of AS 4 "Contingencies* and Events occurring after the Balance Sheet Date" (revised 1995) given in Appendix I at the end of the Study Material (Volume-II).

5.1 Introduction

Pursuant to AS 29 'Provisions, Contingent Liabilities and Contingent Assets, becoming mandatory in respect of accounting periods commencing on or after 1st April, 2004, all paragraphs of AS 4 dealing with contingencies stand withdrawn except to the extent they deal with impairment of assets not covered by any other Indian AS. The project of revision of this standard by ASB in the light of newly issued AS 29 is under progress. Thus, the present standard (AS 4) deals with the treatment and disclosure requirements in the financial statements of events occurring after the balance sheet. Events occurring after the balance sheet date are those significant events (favourable as well unfavourable) that occur between the balance sheet date and the date on which financial statements are approved by the approving authority (i.e. board of directors in case of a company) of any entity.

This revised standard comes into effect in respect of accounting periods commencing on or after 1.4.1995 and is mandatory in nature.

5.2 Contingencies

Contingency is a condition or situation, the ultimate outcome of which, gain or loss, will be known or determined only on the occurrence, or non-occurrence, of one or more uncertain future events. *(Refer to unit 29 for discussion on AS 29)*

5.3 Events Occurring after the Balance Sheet Date

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

For example, for the year ending on 31st March 2010, financial statement is finalized and approved by the company in its AGM held on 04th September 2010. In this case the events taking place between 01st April 2010 to 04th September 2010 are termed as events occurring after the balance sheet date.

Two types of events can be identified

a. those which provide further evidence of conditions that existed at the balance sheet

* Pursuant to AS 29 'Provisions, Contingent Liabilities and Contingent Assets, becoming mandatory in respect of accounting periods commencing on or after 1st April, 2004, all paragraphs of AS 4 dealing with contingencies stand withdrawn except to the extent they deal with impairment of assets not covered by any other Indian AS.

date. For example a debtor declared insolvent and estate unable to pay full amount against whom provision for doubtful debt was created.

b. those which are indicative of conditions that arose subsequent to the balance sheet date. An event which ceases the enterprise from being going concern.

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

Adjustments to assets and liabilities are not appropriate for events occurring after the balance sheet date, if such events do not relate to conditions existing at the balance sheet date. An example is the decline in market value of investments between the balance sheet date and the date on which the financial statements are approved. Events occurring after the balance sheet date which do not affect the figures stated in the financial statements would not normally require disclosure in the financial statements although they may be of such significance that they may require a disclosure in the report of the approving authority to enable users of financial statements to make proper evaluations and decisions.

There are events which, although take place after the balance sheet date, are sometimes reflected in the financial statements because of statutory requirements or because of their special nature. Such items include the amount of dividend proposed or declared by the enterprise after the balance sheet date in respect of the period covered by the financial statements.

Assets and liabilities should be adjusted for events occurring after the balance sheet date that indicate that the fundamental accounting assumption of going concern (ie existence or substratum of the enterprise) is not appropriate.

5.4 Disclosure

Disclosure of events occurring after the balance sheet date require the following information should be provided:

(a) The nature of the event;

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

5.5 Illustrations

Illustration 1

Pure Oil Ltd. closed the books of accounts on March 31, 2012 for which financial statement was finalized by the Board of Directors on September 04, 2012. During the month of December 2011, company under took the project of laying a pipeline across the country and during May 2012 engineers realized that due to unexpected heavy rain, the total cost of the *project will be inflated by ₹ 50 lakhs. How this should be provided for in the balance sheet of 2011-12 accordance to AS 4?*

Solution

This event occurred after March 31, 2012 but before September 04, 2012 is an event occurring after the balance sheet date. But this event is not affecting financial position on the date of balance sheet therefore it should be disclosed in the financial statement by the directors.

Illustration 2

In preparing the financial statements of R Ltd. for the year ended 31st March, 2012, you come across the following information. State with reasons, how you would deal with this in the financial statements:

The company invested 100 lakhs in April, 2012 in the acquisition of another company doing similar business, the negotiations for which had started during the year.

Solution

Para 3.2 of AS 4 (Revised) defines "Events Occurring after the Balance Sheet Date" as those significant events, both favourable and unfavourable, that occur between the balance sheet date and the date on which the financial statements are approved by the Board of Directors in the case of a company. Accordingly, the acquisition of another company is an event occurring after the balance sheet date. However, no adjustment to assets and liabilities is required as the event does not affect the determination and the condition of the amounts stated in the financial statements for the year ended 31st March, 2012. Applying para 15 which clearly states that/disclosure should be made in the report of the approving authority of those events occurring after the balance sheet date that represent material changes and commitments affecting the financial position of the enterprise, the investment of ₹ 100 lakhs in April, 2012 in the acquisition of another company should be disclosed in the report of the Board of Directors to enable users of financial statements to make proper evaluations and decisions.

Illustration 3

A Limited Company closed its accounting year on 30.6.2011 and the accounts for that period were considered and approved by the board of directors on 20th August, 2011. The company was engaged in laying pipe line for an oil company deep beneath the earth. While doing the boring work on 1.9.2011 it had met a rocky surface for which it was estimated that there would be an extra cost to the tune of ₹ 80 lakhs. You are required to state with reasons, how the event would be dealt with in the financial statements for the year ended 30.6.2011.

Solution

Para 3.2 of AS 4 (Revised) on Contingencies and Events Occurring after the Balance Sheet Date defines 'events occurring after the balance sheet date' as 'significant events, both favourable and unfavourable, that occur between the balance sheet date and the date on which financial statements are approved by the Board of Directors in the case of a company'.

The given case is discussed in the light of the above mentioned definition and requirements given in paras 13-15 of the said AS 4 (Revised).

In this case the incidence, which was expected to push up cost became evident after the date of approval of the accounts. So that was not an 'event occurring after the balance sheet date'. However, this may be mentioned in the Directors' Report.

Illustration 4

While preparing its final accounts for the year ended 31st March, 2012 a company made a provision for bad debts @ 5% of its total debtors. In the last week of February, 2012 a debtor for ₹ 2 lakhs had suffered heavy loss due to an earthquake; the loss was not covered by any insurance policy. In April, 2012 the debtor became a bankrupt. Can the company provide for the full loss arising out of insolvency of the debtor in the final accounts for the year ended 31st March, 2012?

Solution

As per paras 8.2 and 13 of Accounting Standard 4 on Contingencies and Events Occurring after the Balance Sheet Date, Assets and Liabilities should be adjusted for events occurring after the balance sheet date that provide additional evidence to assist estimation of amounts relating to conditions existing at the balance sheet date.

So full provision for bad debt amounting to ₹ 2 lakhs should be made to cover the loss arising due to the insolvency in the Final Accounts for the year ended 31st March, 2012. It is because earthquake took place before the balance sheet date.

Had the earthquake taken place after 31st March, 2012, then mere disclosure required as per para 15, would have been sufficient.

UNIT 6 : AS 5: NET PROFIT OR LOSS FOR THE PERIOD, PRIOR PERIOD ITEMS AND CHANGES IN ACCOUNTING POLICIES

Reference: The students are advised to refer the full text of AS 5 "Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies" (revised 1997) given in Appendix I at the end of the Study Material (Volume-II)

6.1 Introduction

This revised standard AS 5 comes into effect in respect of accounting periods commencing on or after 1.4.1996 and is mandatory in nature.

The objective of AS 5 is to prescribe the classification and disclosure of certain items in the statement of profit and loss so that all enterprises prepare and present such a statement on a uniform basis. This enhances the comparability of the financial statements of an enterprise over time and with the financial statements of other enterprises. Accordingly, this Standard requires the classification and disclosure of extraordinary and prior period items, and the disclosure of certain items within profit or loss from ordinary activities. It also specifies the accounting treatment for changes in accounting estimates and the disclosures to be made in the financial statements regarding changes in accounting policies.

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

6.2 Net Profit or Loss for the Period

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

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

(b) Extraordinary items: Income or expenses that arise from events or transactions that are clearly distinct from the ordinary activities of the enterprise and, therefore, are not expected to recur frequently or regularly. For example, profit on sale of furniture or heavy loss of goods due to fire.

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

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

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

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

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

(c) Disposals of items of fixed assets.

(d) Disposals of long-term investments.

(e) Legislative changes having retrospective application.

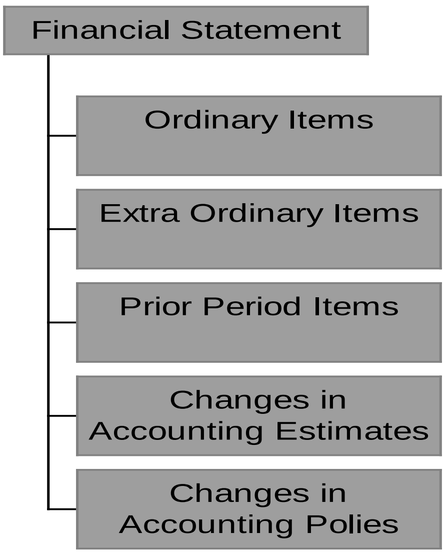
(f) Litigation settlements.

(g) Other reversals of provisions.

6.3 Prior Period Items

Prior period items are income or expenses which arise in the current period as a result of

Disclosure under Following Category



errors or omissions in the preparation of the financial statements of one or more prior periods. Prior period items are generally infrequent in nature and can be distinguished from changes in accounting estimates.

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

For example, Mr. Sachin purchased a new machine costing ₹ 10 lacs. Useful life was taken to be for 10 years therefore depreciation was charged at 10% on original cost each year. After 5 years when carrying amount was ₹ 5 lacs for the machine, management realizes that machine can work for another 2 years only and they decide to write off ₹ 2.5 lacs each year. This is not an example of prior period item but change in accounting estimate. In the same example management by mistake calculates the depreciation in the fifth year as 10% of ₹ 6,00,000 i.e. ₹ 60,000 instead of ₹ 1,00,000 and in the next year decides to write off ₹ 1,40,000. ₹ 1,00,000 current year's depreciation and ₹ 40,000 as prior period item.

6.4 Changes in Accounting Estimates

An estimate may have to be revised if changes occur in the circumstances based on which the estimate was made, or as a result of new information, more experience or subsequent developments. The revision of the estimate, by its nature, does not bring the adjustment within the definitions of an extraordinary item or a prior period item.

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

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

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

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

6.5 Changes in Accounting Policies

Accounting policies are the specific accounting principles and the methods of applying those principles adopted by an enterprise in the preparation and presentation of financial statements. A change in an accounting policy should be made only if the adoption of a different accounting policy is required by statute or for compliance with an accounting standard or if it is considered that the change would result in a more appropriate presentation of the financial statements of the enterprise.

The following are not changes in accounting policies:

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

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

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

Accounting Policies can be changed only :

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

6.6 Miscellaneous Illustrations

Illustration 1

Fuel surcharge is billed by the State Electricity Board at provisional rates. Final bill for fuel surcharge of ₹ 5.30 lakhs for the period October, 2007 to September, 2011 has been received and paid in February, 2012.

Solution

The final bill having been paid in February, 2012 should have been accounted for in the annual accounts of the company for the year ended 31st March, 2012. However it seems that as a result of error or omission in the preparation of the financial statements of prior period i.e., for the year ended 31st March 2012, this material charge has arisen in the current period i.e., year ended 31st March, 2013. Therefore it should be treated as 'Prior period item' as per para 16 of AS 5. As per para 19 of AS 5 (Revised), prior period items are normally included in the determination of net profit or loss for the current period. An alternative approach is to show such items in the statement of profit and loss after determination of current net profit or loss. In either case, the objective is to indicate the effect of such items on the current profit or loss.

It may be mentioned that it is an expense arising from the ordinary course of business. Although abnormal in amount or infrequent in occurrence, such an expense does not qualify an extraordinary item as per Para 10 of AS 5 (Revised). For better understanding, the fact that power bill is accounted for at provisional rates billed by the state electricity board and final adjustment thereof is made as and when final bill is received may be mentioned as an accounting policy.

Illustration 2

There was a major theft of stores valued at ₹ 10 lakhs in the preceding year which was detected only during current financial year (2011-2012).How will you deal with this information in preparing the financial statements of R Ltd. for the year ended 31st March, 2012.

Solution

Due to major theft of stores in the preceding year (2010-2011) which was detected only during the current financial year (2011–2012), there was overstatement of closing stock of stores in the preceding year. This must have also resulted in the overstatement of profits of previous year, brought forward to the current year. The adjustments are required to be made in the current year as 'Prior Period Items' as per AS 5 (Revised) on Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies. Accordingly, the adjustments relating to both opening stock of the current year and profit brought forward from the previous year should be separately disclosed in the statement of profit and loss together with their nature and amount in a manner that their impact on the current profit or loss can be perceived.

Note: Alternatively, it may be assumed that in the preceding year, the value of stock of stores as found out by physical verification of stocks was considered in the preparation of financial statements of the preceding year. In such a case, only the disclosure as to the theft and the resulting loss is required in the notes to the accounts for the current year i.e, year ended 31st March, 2012.

Illustration 3

(i) During the year 2011-2012, a medium size manufacturing company wrote down its inventories to net realisable value by ₹ 5,00,000. Is a separate disclosure necessary?

(ii) A Limited company has been including interest in the valuation of closing stock. In 2011-2012 the management of the company decided to follow AS 2 and accordingly interest has been excluded from the valuation of closing stock. This has resulted in a decrease in profits by ₹ 3,00,000. Is a disclosure necessary? If so, draft the same.

(iii) A company signed an agreement with the Employees Union on 1.9.2011 for revision of wages with retrospective effect from 30.9.2010. This would cost the company an additional liability of ₹ 5,00,000 per annum. Is a disclosure necessary for the amount paid in 2011-12?

Solution

(i) Although the case under consideration does not relate to extraordinary item, but the nature and amount of such item may be relevant to users of financial statements in understanding the financial position and performance of an enterprise and in making projections about financial position and performance. Para 12 of AS 5 (Revised in 1997) on Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies states that:

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

Circumstances which may give to separate disclosure of items of income and expense in accordance with para 12 of AS 5 include the write-down of inventories to net realisable value as well as the reversal of such write-downs.

(ii) As per AS 5 (Revised), change in accounting policy can be made for many reasons, one of these is for compliance with an accounting standard. In the instant case, the company has changed its accounting policy in order to conform with the AS 2 (Revised) on Valuation of Inventories. Therefore, a disclosure is necessary in the following lines by way of notes to the annual accounts for the year 2011-2012.

"To be in conformity with the Accounting Standard on Valuation of Inventories issued by ICAI, interest has been excluded from the valuation of closing stock unlike preceding years. Had the same principle been followed in previous years, profit for the year and its corresponding effect on the year end net assets would have been higher by ₹ 3,00,000."

(iii) It is given that revision of wages took place on 1st September, 2012 with retrospective effect from 30.9.2011. Therefore wages payable for the half year from 1.10.2011 to 31.3.2012 cannot be taken as an error or omission in the preparation of financial statements and hence this expenditure cannot be taken as a prior period item.

Additional wages liability of ₹ 7,50,000 (for 1½ years @ ₹ 5,00,000 per annum) should be included in current year's wages.

It may be mentioned that additional wages is an expense arising from the ordinary activities of the company. Although abnormal in amount, such an expense does not qualify as an extraordinary item. However, as per Para 12 of AS 5 (Revised), when items of income and expense within profit or loss from ordinary activities are of such size, nature or incidence that their disclosure is relevant to explain the performance of the enterprise for the period, the nature and amount of such items should be disclosed separately.

Illustration 4

While preparing its final accounts for the year ended 31st March, 2012 Rainbow Limited created a provision for Bad and Doubtful debts are 2% on trade debtors. A few weeks later the company found that payments from some of the major debtors were not forthcoming. Consequently the company decided to increase the provision by 10% on the debtors as on 31st March, 2012 as the accounts were still open awaiting approval of the Board of Directors. Is this to be considered as an extra-ordinary item or prior period item ? Comment.

Solution

The preparation of financial statements involve making estimates which are based on the circumstances existing at the time when the financial statements are prepared. It may be necessary to revise an estimate in a subsequent period if there is a change in the circumstances on which the estimate was based. Revision of an estimate does not bring the resulting amount within the definition either of prior period item or of an extraordinary item [para 21, AS 5 (Revised)].

In the given case, Rainbow Limited created a provision for bad and doubtful debts at 2% on trade debtors while preparing its final accounts for the year ended 31st March, 2012. Subsequently, the company decided to increase the provision by 10%. As per AS 5 (Revised), this change in estimate is neither a prior period item nor an extraordinary item.

However, as per para 27 of AS 5 (Revised), a change in accounting estimate which has a material effect in the current period should be disclosed and quantified. Any change in an accounting estimate which is expected to have a material effect in later periods should also be disclosed.

Illustration 5

The company finds that the stock sheets of 31.3.2011 did not include two pages containing details of inventory worth ₹ 14.5 lakhs. State, how you will deal with the following matters in the accounts of Omega Ltd. for the year ended 31st March, 2012.

Solution

Paragraph 4 of Accounting Standard 5 on Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies, defines Prior Period items as "income or expenses which arise in the current period as a result of errors or omissions in the preparation of the financial statements of one or more prior periods".

Rectification of error in stock valuation is a prior period item vide Para 4 of AS 5. ₹14.5 lakhs must be added to the opening stock of 1.4.2011. It is also necessary to show ₹ 14.5 lakhs as a prior period adjustment in the Profit and loss Account below the line. Separate disclosure of this item as a prior period item is required as per Para 15 of AS 5.

UNIT 7 : AS 6 : DEPRECIATION ACCOUNTING

Reference: The students are advised to refer the full text of AS 6 "Depreciation Accounting" (revised 1994) given in Appendix I at the end of the Study Material (Volume-II).

7.1 Introduction

This revised standard comes into effect in respect of accounting periods commencing on or after 1.4.1996 and is mandatory in nature.

This Statement deals with depreciation accounting and applies to all depreciable assets, except the following items to which special considerations apply: -

(i) Forests, plantations and similar regenerative natural resources;

(ii) Wasting assets including expenditure on the exploration for and extraction of minerals, oils, natural gas and similar non-regenerative resources;

(iii) Expenditure on research and development;

(iv) Goodwill;

(v) Live stock:- Cattle, Animal Husbandry

This statement also does not apply to land unless it has useful life for the enterprise.

7.2 Depreciation

Depreciation is a measure of the wearing out, consumption or other loss of value of a depreciable asset arising from use, effluxion of time or obsolescence through technology and market changes. Depreciation is allocated so as to charge a fair proportion of the depreciable amount in each accounting period during the expected useful life of the asset. Depreciation includes amortisation of assets whose useful life is predetermined.

7.3 Depreciable Assets

Depreciable assets are assets which

(i) Are expected to be used during more than one accounting period. Dies and blocks are written off on first year itself as their useful life ends within one year.

(ii) Have a limited useful life. Depreciation is not charged on land as the useful of land cannot be determined, it is endless.

(iii) Are held by an enterprise for use in the production or supply of goods and services, for rental to others, or for administrative purposes and not for the purpose of sale in the ordinary course of business. Depreciation is not charged on assets purchased for the purpose of resale but could not be sold till the end of the accounting year.

7.4 Depreciable Amount

Depreciable amount of a depreciable asset is its historical cost, or other amount substituted for historical cost in the financial statements, less the estimated residual value.

Depreciable Amount = Historical Cost – Residual Value.

Assessment of depreciation and the amount to be charged in respect thereof in an accounting period are usually based on the following three factors:

(i) Historical cost or other amount substituted for the historical cost of the depreciable asset when the asset has been revalued;

(ii) Expected useful life of the depreciable asset; and

(iii) Estimated residual value of the depreciable asset.

7.5 Historical Cost

Historical cost of a depreciable asset represents its money outlay or its equivalent in connection with its acquisition, installation and commissioning as well as for additions to or improvement thereof.

For example, Mr. Rahul imported machine from Germany on the condition that machine will be run on trail basis for 15 days, if machine works perfectly it will be purchased or else it will be rejected. Now since trial run is the necessary condition for acquisition of the machinery, the cost incurred for trail run net of any revenue generated will be capitalized i.e. added to the historical cost of the machine.

The historical cost of a depreciable asset may undergo subsequent changes arising as a result of increase or decrease in long term liability on account of exchange fluctuations, price adjustments, changes in duties or similar factors.

Illustration 1

Mr. X set up a new factory in the backward area and purchased plant for ₹ 500 lakhs for the purpose. Purchases were entitled for the CENVAT credit of ₹ 10 lakhs and also Government agreed to extend the 25% subsidy for backward area development. Determine the depreciable value for the asset.

Solution

Particulars	*₹ (in lakhs)*
Cost of the plant	500
Less: CENVAT	(10)
	490
Less: Subsidy	(98)
Depreciable Value	392

7.6 Useful Life

Useful life of a depreciable asset is shorter than its physical life. Useful life depends upon the following factors

(i) Pre-determined by legal or contractual limits

Example- Asset given on lease, the estimated life is period of lease.

(ii) Depends upon the number of shifts for which the asset is to be used.

(iii) Repair and Maintenance policy of enterprise.

(iv) Technological obsolescence

(v) Innovation/ improvements in the production method.

(vi) Change in demand of output.

(vii) Legal or other restrictions.

Useful life is either

(i) The period over which a depreciable asset is expected to be used by the enterprise; or

(ii) The number of production or similar units expected to be obtained from the use of the asset by the enterprise.

7.7 Additions to Existing Assets

Any addition or extension to an existing asset which is of a capital nature and which becomes an integral part of the existing asset is depreciated over the remaining useful life of that asset. As a practical measure, however, depreciation is sometimes provided on such addition or extension at the rate which is applied to an existing asset. Any addition or extension which retains a separate identity and is capable of being used after the existing asset is disposed of, is depreciated independently on the basis of an estimate of its own useful life.

For example, the engine of an aircraft is replace, in this case since the life of engine is not depended on the life of the aircraft body, depreciation charged on both is recorded separately.

7.8 Amount of Depreciation

The quantum of depreciation to be provided in an accounting period involves the exercise of judgement by management in the light of technical, commercial, accounting and legal requirements and accordingly may need periodical review. If it is considered that the original estimate of useful life of an asset requires any revision, the unamortised depreciable amount of the asset is charged to revenue over the revised remaining useful life.

7.9 Methods of Depreciation

There are several methods of allocating depreciation over the useful life of the assets. Those most commonly employed in industrial and commercial enterprises are the straightline method and the reducing balance method. The management of a business selects the most appropriate method(s) A combination of more than one method is sometimes used. In respect of depreciable assets which do not have material value, depreciation is often allocated fully in the accounting period in which they are acquired, e.g. books.

(a) *Straight Line Method:* An equal amount is written off every year during the working life on an asset so as to reduce the cost of the asset to NIL or to its residual value at the end of its useful life.

$$\text{Straight Line Depreciation} = \frac{\text{Cost of Asset} - \text{Scrap Value}}{\text{Useful Life}}$$

$$\text{Depreciation Rate} = \frac{\text{Straight Line Depreciation} \times 100}{\text{Cost of Asset}}$$

This method of charging depreciation is recommended mostly for power generating units or for the assets where danger of obselence is low.

(b) *Reducing Balance/Written Down Value Method:* A fixed percentage of the diminishing value of the asset is written off each year so as to reduce the asset to its salvage value at the end of its life.

$$\text{Depreciation Rate} = \frac{1}{n}\left[\frac{\text{Residual Value}}{\text{Cost of Asset}} \times 100\right]$$

n = useful life.

This method is highly recommended mainly for manufacturing units though it is recommended for most of the enterprises.

Distinction between Straight Line and Written Down Value Method:

	Straight Line Method	Written Down Value
1.	Amount of depreciation is calculated at a fixed percentage on the original cost of the fixed asset.	Amount of depreciation is calculated at a fixed percentage on written down value of the fixed amount.
2.	Amount of depreciation remains same year to year.	Amount of depreciation decreases year to year.
3.	At the end of the life, the value of asset can be zero.	The value of assets never comes to zero.
4.	It is also known as Fixed Instalment Method or Constant Charge Method.	It is also known as Reducing or Diminishing Balance Method.
5.	It is easy to calculate.	It is difficult to calculate.
6.	Depreciation + Repair keeps increasing.	Depreciation + Repairs more or less remains constant.
7.	Suitable for the assets that requires fewer repairs.	Suitable for assets, which requires more repairs with passage of time.

(c) *Sum of the Year Digit Method (SYD):* Under this method, the rate of depreciation is charged on the original cost. However, the rate of depreciation for each year is a fraction in which the denominator is the sum of the year digits from 1 to n and numerator for the first year is n, for the second year n-1, for the third year n-2 and so on.

Rate of Depreciation for each year is = $\frac{n-(x-1)}{n(n+1)/2}$

Where, n = useful life of the asset.

x = number of years asset is in use.

(d) *Machine Hour Method:* Where it is practically possible to keep a record of the actual running hours of each machine, depreciation may be calculated on the basis of hours that the concerned machine worked.

Depreciation for year 'n' = $\frac{\text{Hours worked in n x (Cost - Salvage Value)}}{\text{Total Estimated Working Hours}}$

This method is recommended for the assets mainly machinery, where in the cost of the asset was determined mainly based on the useful working hours of the machine.

(e) *Depletion Method:* This method is used in case of mines, quarries etc. containing only a certain quantity of product. The depreciation rate is calculated by dividing the cost of the asset by the estimated quantity of product likely to be available.

Depreciation for year 'n' = $\frac{\text{Qty. Extracted / Produced in 'n'} \times \text{(Cost - Residual Value)}}{\text{Total Estimated Quantity}}$

(f) *Annuity Method:* This is a method of depreciation which also takes into account the element of interest on capital outlay and seeks to write off the value of the asset as well as the interest lost over the life of the asset. On that basis, the amount of depreciation to be annually provided in the account is ascertained from the Annuity Tables. Though the amount written off annually is constant, the interest in the earlier years being greater, only small amount of the capital outlay is written off. This proportion is reversed with the passage of time.

This method of charging depreciation is mostly recommended for leasehold assets.

(g) *Sinking Fund Method:* If the sum involved in replacing the asset is large, than just providing for depreciation will not be sufficient, as because the concern may not have the ready fund available to replace the assets. For this purpose a Sinking Fund Account is created, a depreciation amount is credited to it. The amount is invested in some Government Securities. Every year the process is repeated, the interest received from such securities are also reinvested and these securities are sold at the end of the life of the asset, so that the concern has the ready fund to replace the asset.

7.10 Basis for Computation of Depreciation

The statute governing an enterprise may provide the basis for computation of the depreciation. Where the management's estimate of the useful life of an asset of the enterprise is shorter than that envisaged under the provisions of the relevant statute, the depreciation provision is appropriately computed by applying a higher rate. If the management's estimate of the useful life of the asset is longer than that envisaged under the statute, depreciation rate lower than that envisaged by the statute can be applied only in accordance with requirements of the statute.

7.11 Disposal of Assets

Where depreciable assets are disposed of, discarded, demolished or destroyed, the net surplus or deficiency, if material, is disclosed separately.

7.12 Change in Method of Depreciation

When such a change in the method of depreciation is made, depreciation is recalculated in accordance with the new method from the date of the asset coming into use. The deficiency or surplus arising from retrospective re-computation of depreciation in accordance with the new method is adjusted in the accounts in the year in which the method of depreciation is changed and it is charged or credited to Profit & Loss Account as per the case.

Such a change is treated as a change in accounting policy and its effect is quantified and disclosed.

Illustration 2

Mr. A purchased a machine on 01.04.2007 for ₹ 1,00,000. On 01.07.2008 he purchased another machine for ₹ 1,50,000. On 01.10.2009, he purchased the third machine for ₹ 2,00,000 and on 31.12.2010 he sold the second machine for ₹ 1,25,000. On 31.03.2012 he decided to change the method of charging depreciation from Straight Line Method @ 10% p.a. to Written Down Value Method @ 15%.

Solution

Working Note 1: Depreciation charged under old method:

Particulars	₹	₹
Purchase of first machine	100,000	
Depreciation for 4 years (1,00,000 x 10% x 4)		40,000
Purchase of third machine	200,000	
Depreciation for 1.5 years (2,00,000 x 10% x 1.5)		30,000
Total Depreciation charged		70,000

Working Note 2: Depreciation to be charged under new method:

Year	*Opening WDV* ₹	*Purchases* ₹	*Balance* ₹	*Depreciation* ₹	*Closing WDV* ₹
2007-08	---	100,000	100,000	15,000	85,000
2008-09	85,000	---	85,000	12,750	72,250
2009-10	72,250	200,000	272,250	40,838	231,412
2010-11	231,412	---	231,412	34,712	196,700
		Total Depreciation		1,03,300	

Machine Account

Dr. *Cr.*

Date	*Particulars*	₹	*Date*	*Particulars*	₹
01.04.2007	To Bank	1,00,000	31.03.2008	By Depreciation	10,000
				By Balance C/d.	90,000
		1,00,000			1,00,000
01.04.2008	To Balance B/d.	90,000	31.03.2009	By Depreciation	21,250
01.07.2008	To Bank	1,50,000		By Balance C/d.	2,18,750
		2,40,000			2,40,000
01.04.2009	To Balance B/d.	2,18,750	31.03.2010	By Depreciation	35,000
01.10.2009	To Bank	2,00,000		By Balance C/d.	3,83,750
		4,18,750			4,18,750
01.04.2010	To Balance B/d.	383,750	31.12.2010	By Bank	125,000
31.12.2010	To Profit on Sale	12,500	31.03.2011	By Depreciation	41,250
				By Balance C/d.	2,30,000
		3,96,250			3,96,250
01.04.2011	To Balance B/d.	2,30,000	31.03.2012	By Profit & Loss A/c.	33,300
				By Depreciation (1,96,700 x 15%)	29,505
				By Balance C/d.	1,67,195
		2,30,000			2,30,000
01.04.2012	To Balance B/d.	1,67,195			

7.13 Disclosure

(1) The depreciation methods used,

(2) The total depreciation for the period for each class of assets,

(3) The gross amount of each class of depreciable assets and the related accumulated depreciation are disclosed in the financial statements along with the disclosure of other accounting policies.

(4) The depreciation rates or the useful lives of the assets are disclosed only if they are different from the principal rates specified in the statute governing the enterprise.

(5) In case the depreciable assets are revalued, the provision for depreciation is based on the revalued amount on the estimate of the remaining useful life of such assets. In case the revaluation has a material effect on the amount of depreciation, the same is disclosed separately in the year in which revaluation is carried out.

A change in the method of depreciation is treated as a change in an accounting policy and is disclosed accordingly.

UNIT 8 : AS 7: CONSTRUCTION CONTRACTS

Reference: The students are advised to refer the full text of AS 7 "Construction Contracts" (revised 2002) given in Appendix I at the end of the Study Material (Volume-II).

8.1 Introduction

AS 7, comes into effect in respect of all contracts entered into during accounting periods commencing on or after 1-4-2003 and is mandatory in nature. This Statement should be applied in accounting for construction contracts in the financial statements of contractors. The standard prescribes the accounting treatment of revenue and costs associated with construction contracts by laying down the guidelines regarding allocation of contract revenue and contract costs to the accounting periods in which the construction work is performed, since the construction activity is generally contracted and completed in more than one accounting period.

8.2 Definitions of the Terms used in the Standard

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

A fixed price contract is a construction contract in which the contractor agrees to a fixed contract price, or a fixed rate per unit of output, which in some cases is subject to cost escalation clauses.

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

8.3 Combining and Segmenting Construction Contracts

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

(a) Separate proposals have been submitted for each asset;

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

(c) The costs and revenues of each asset can be separately identified.

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

(a) The group of construction contracts is negotiated as a single package;

(b) The contracts are so closely interrelated that they are, in effect, part of a single project with an overall profit margin; and

(c) The contracts are performed concurrently or in a continuous sequence.

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

(a) The asset differs significantly in design, technology or function from the asset or assets covered by the original contract; or

(b) The price of the asset is negotiated without regard to the original contract price.

8.4 Contract Revenue

Contract revenue should comprise:

(a) The initial amount of revenue agreed in the construction contract; and

(b) Variations in contract work, claims and incentive payments:

 (i) To the extent that it is probable that they will result in revenue; and

 (ii) They are capable of being reliably measured.

Contract revenue is measured at the consideration received or receivable. The measurement of contract revenue is affected by a variety of uncertainties that depend on the outcome of future events. The estimates often need to be revised as events occur and uncertainties are resolved. Therefore, the amount of contract revenue may increase or decrease from one period to the next. For example:

(a) A contractor and a customer may agree to variations or claims that increase or decrease contract revenue in a period subsequent to that in which the contract was initially agreed;

(b) The amount of revenue agreed in a fixed price contract may increase as a result of cost escalation clauses;

(c) The amount of contract revenue may decrease as a result of penalties arising from delays caused by the contractor in the completion of the contract; or

(d) When a fixed price contract involves a fixed price per unit of output, contract revenue increases/ decreases as the number of units is increased/ decreased.

8.5 Contract Costs

Contract costs should comprise:

(a) Costs that relate directly to the specific contract;

1. Site labour costs, including site supervision;
2. Costs of materials used in construction;
3. Depreciation of plant and equipment used on the contract;
4. Costs of moving plant, equipment and materials to and from the contract site;
5. Costs of hiring plant and equipment;
6. Costs of design and technical assistance that aredirectly related to the contract;
7. The estimated costs of rectification and guarantee work, including expected warranty costs; and
8. Claims from third parties.

(b) Costs that are attributable to contract activity in general and can be allocated to the contract; and

1. Insurance;
2. Costs of design and technical assistance that are not directly related to a specific contract; and
3. Construction overheads.
4. Borrowing costs capitalized under AS 16 Borrowing cost

(c) Such other costs as are specifically chargeable to the customer under the terms of the contract.

Costs that cannot be attributed to contract activity or cannot be allocated to a contract are excluded from the costs of a construction contract. Such costs include:

(a) General administration costs for which reimbursement is not specified in the contract;

(b) Selling costs;

(c) Research and development costs for which reimbursement is not specified in the contract; and

(d) Depreciation of idle plant and equipment that is not used on a particular contract.

8.6 Recognition of Contract Revenue and Expenses

When the outcome of a construction contract can be estimated reliably, contract revenue and contract costs associated with the construction contract should be recognised as revenue and expenses respectively by reference to the stage of completion of the contract activity at the reporting date. An expected loss on the construction contract should be recognised as an expense immediately.

In the case of a fixed price contract, the outcome of a construction contract can be estimated reliably when all the following conditions are satisfied:

(a) Total contract revenue can be measured reliably;

(b) It is probable that the economic benefits associated with the contract will flow to the enterprise;

(c) Both the contract costs to complete the contract and the stage of contract completion at the reporting date can be measured reliably; and

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

In the case of a cost plus contract, the outcome of a construction contract can be estimated reliably when both the following conditions are satisfied:

(a) It is probable that the economic benefits associated with the contract will flow to the enterprise; and

(b) The contract costs attributable to the contract, whether or not specifically reimbursable, can be clearly identified and measured reliably.

When an uncertainty arises about the collectability of an amount already included in contract revenue, and already recognised in the statement of profit and loss, the uncollectable amount or the amount in respect of which recovery has ceased to be probable is recognised as an expense rather than as an adjustment of the amount of contract revenue. The stage of completion of a contract may be determined in a variety of ways. The enterprise uses the method that measures reliably the work performed. Depending on the nature of the contract, the methods may include:

(a) The proportion that contract costs incurred for work performed upto the reporting date bear to the estimated total contract costs; or

(b) Surveys of work performed; or

(c) Completion of a physical proportion of the contract work.

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

When the outcome of a construction contract cannot be estimated reliably:

(a) Revenue should be recognised only to the extent of contract costs incurred of which recovery is probable; and

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

An expected loss on the construction contract should be recognised as an expense immediately. During the early stages of a contract it is often the case that the outcome of the contract cannot be estimated reliably. Nevertheless, it may be probable that the enterprise will recover the contract costs incurred. Therefore, contract revenue is recognised only to the extent of costs incurred that are expected to be recovered. As the outcome of the contract cannot be estimated reliably, no profit is recognised. However, even though the outcome of the contract cannot be estimated reliably, it may be probable that total contract costs will exceed total contract revenue. In such cases, any expected excess of total contract costs over total contract revenue for the contract is recognised as an expense immediately.

The percentage of completion method is applied on a cumulative basis in each accounting period to the current estimates of contract revenue and contract costs. Therefore, the effect of a change in the estimate of contract revenue or contract costs, or the effect of a change in the estimate of the outcome of a contract, is accounted for as a change in accounting estimate.

8.7 Disclosure

An enterprise should disclose:

(a) The amount of contract revenue recognised as revenue in the period;

(b) The methods used to determine the contract revenue recognised in the period; and

(c) The methods used to determine the stage of completion of contracts in progress.

An enterprise should disclose the following for contracts in progress at the reporting date:

(a) The aggregate amount of costs incurred and recognised profits (less recognised losses) to date

(b) The amount of advances received; and

(c) The amount of retentions.

Advances are recognized as liabilities until the related revenue is earned.

'Retentions' are amounts of progress billings that are not paid until the satisfaction of conditions specified in the contract for the payment of such amounts or until defects have been rectified. Retentions are recognized as receivables in the balance sheet of the contractor. An enterprise should present:

(a) The gross amount due from customers for contract work as an asset; and

(b) The gross amount due to customers for contract work as a liability.

8.8 Illustrations

Illustration 1

A firm of contractors obtained a contract for construction of bridges across river Revathi. The following details are available in the records kept for the year ended 31st March, 2012.

	(₹ in lakhs)
Total Contract Price	*1,000*
Work Certified	*500*
Work not Certified	*105*
Estimated further Cost to Completion	*495*
Progress Payment Received	*400*
To be Received	*140*

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

Solution

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

According to para 35 of AS 7 (Revised 2002), when it is probable that total contract costs will exceed total contract revenue, the expected loss should be recognized as an expense immediately.

(b)	Contract work-in-progress i.e. cost incurred to date are ₹ 605 lakhs	*(₹ in lakhs)*
	Work certified	500
	Work not certified	105
		605

This is 55% (605/1,100 ´ 100) of total costs of construction.

(c) Proportion of total contract value recognised as revenue as per para 21 of AS 7 (Revised).

55% of ₹ 1,000 lakhs = ₹ 550 lakhs

(d) Amount due from/to customers = Contract costs + Recognised profits – Recognised losses – (Progress payments received + Progress payments to be received)

= [605 + Nil – 100 – (400 + 140)] ₹ in lakhs

= [605 – 100 – 540] ₹ in lakhs

Amount due to customers = ₹ 35 lakhs

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

(e) The relevant disclosures under AS 7 (Revised) are given below:

	₹ in lakhs
Contract revenue	550
Contract expenses	605
Recognised profits less recognized losses	(100)
Progress billings ₹ (400 + 140)	540
Retentions (billed but not received from contractee)	140
Gross amount due to customers	35

Illustration 2

On 1st December, 2011, Vishwakarma Construction Co. Ltd. undertook a contract to construct a building for ₹ 85 lakhs. On 31st March, 2012, the company found that it had already spent ₹ 64,99,000 on the construction. Prudent estimate of additional cost for completion was ₹ 32,01,000. What amount should be charged to revenue in the final accounts for the year ended 31st March, 2012 as per provisions of Accounting Standard 7 (Revised)?

Solution

(a)		₹
	Cost incurred till 31st March, 2012	64,99,000
	Prudent estimate of additional cost for completion	32,01,000
	Total cost of construction	97,00,000
	Less: Contract price	(85,00,000)
	Total foreseeable loss	12,00,000

According to para 35 of AS 7 (Revised 2002), the amount of ₹ 12,00,000 is required to be recognized as an expense.

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

Proportion of total contract value recognized as turnover as per para 21 of AS 7 (Revised) on Construction Contracts.

= 67% of ₹ 85,00,000 = ₹ 56,95,000.

UNIT 9 : AS 9: REVENUE RECOGNITION

Reference: The students are advised to refer the full text of AS 9 "Revenue Recognition" (issued 1985) given in Appendix I at the end of the Study Material (Volume-II).

9.1 Introduction

This statement was issued by ICAI in the year 1985 and in the initial years it was recommendatory for only level I enterprises and but was made mandatory for enterprise in India from April 01, 1993.

9.2 Revenue

Revenue is the gross inflow of cash, receivables or other consideration arising in the course of the ordinary activities of an enterprise from the sale of goods, from the rendering of services, and from the use by others of enterprise resources yielding interest, royalties and dividends. Revenue is measured by the charges made to customers or clients for goods supplied and services rendered to them and by the charges and rewards arising from the use of resources by them. In an agency relationship, the revenue is the amount of commission and not the gross inflow of cash, receivables or other consideration.

This Statement does not deal with the following aspects of revenue recognition to which special considerations apply:

(i) Revenue arising from construction contracts;

(ii) Revenue arising from hire-purchase, lease agreements;

(iii) Revenue arising from government grants and other similar subsidies;

(iv) Revenue of insurance companies arising from insurance contracts.

Examples of items not included within the definition of "revenue" for the purpose of this Statement are:

(i) Realised gains resulting from the disposal of, and unrealised gains resulting from the holding of, non-current assets e.g. appreciation in the value of fixed assets;

(ii) Unrealised holding gains resulting from the change in value of current assets, and the natural increases in herds and agricultural and forest products;

(iii) Realised or unrealised gains resulting from changes in foreign exchange rates and adjustments arising on the translation of foreign currency financial statements;

(iv) Realised gains resulting from the discharge of an obligation at less than its carrying amount;

(v) Unrealised gains resulting from the restatement of the carrying amount of an obligation.

9.3 Sale of Goods

A key criterion for determining when to recognise revenue from a transaction involving the sale of goods is that the seller has transferred the property in the goods to the buyer for a consideration. The transfer of property in goods, in most cases, results in or coincides with the transfer of significant risks and rewards of ownership to the buyer. However, there may be situations where transfer of property in goods does not coincide with the transfer of significant risks and rewards of ownership. Revenue in such situations is recognised at the time of transfer of significant risks and rewards of ownership to the buyer. At certain stages in specific industries, such as when agricultural crops have been harvested or mineral ores have been extracted, performance may be substantially complete prior to the execution of the transaction generating revenue. In such cases when sale is assured under a forward contract or a government guarantee or where market exists and there is a negligible risk of failure to sell, the goods involved are often valued at net realisable value. Such amounts, while not revenue as defined in this Statement, are sometimes recognised in the statement of profit and loss and appropriately described.

9.4 Rendering of Services

Revenue from service transactions is usually recognised as the service is performed, either by the proportionate completion method or by the completed service contract method.

Proportionate completion method is a method of accounting which recognises revenue in the statement of profit and loss proportionately with the degree of completion of services under a contract. Here performance consists of the execution of more than one act. Revenue is recognised proportionately by reference to the performance of each act.

Completed service contract method is a method of accounting which recognises revenue in the statement of profit and loss only when the rendering of services under a contract is completed or substantially completed. In this method performance consists of the execution of a single act. Alternatively, services are performed in more than a single act, and the services yet to be performed are so significant in relation to the transaction taken as a whole that performance cannot be deemed to have been completed until the execution of those acts. The completed service contract method is relevant to these patterns of performance and accordingly revenue is recognised when the sole or final act takes place and the service becomes chargeable

9.5 Interest, Royalties and Dividends

The use by others of such enterprise resources gives rise to:

(i) Interest: charges for the use of cash resources or amounts due to the enterprise. Revenue is recognized on a time proportion basis taking into account the amount outstanding and the rate applicable. For example, debenture interest payable on every June 30th and December 31st. On March 31st when books will be closed, though interest has not fallen due but still interest for the period January, February and March will be recognised on time basis.

(ii) **Royalties:** charges for the use of such assets as know-how, patents, trade marks and copyrights. Revenue is recognized on an accrual basis in accordance with the terms of the relevant agreement. If agreement is signed for royalty payable on the basis of the number of copies of the book published, it will be recognised on that basis only.

(iii) **Dividends:** rewards from the holding of investments in shares. Revenue is recognized when the owner's right to receive payment is established. Unless company declare dividend on the shares, it is not certain. Therefore it is recognised only when directors actually decides to pay dividend to their shareholders.

9.6 Effect of Uncertainties on Revenue Recognition

Where the ability to assess the ultimate collection with reasonable certainty is lacking at the time of raising any claim, revenue recognition is postponed to the extent of uncertainty involved. In such cases:

When the uncertainty relating to collectability arises subsequent to the time of sale or the rendering of the service, it is more appropriate to make a separate provision to reflect the uncertainty rather than to adjust the amount of revenue originally recorded.

An essential criterion for the recognition of revenue is that the consideration receivable for the sale of goods, the rendering of services or from the use by others of enterprise resources is reasonably determinable. When such consideration is not determinable within reasonable limits, the recognition of revenue is postponed.

9.7 Disclosure

An enterprise should disclose the circumstances in which revenue recognition has been postponed pending the resolution of significant uncertainties.

Revised ASI 14, Disclosure of Revenue from Sales Transactions (Re.: AS 9):

The amount of turnover should be disclosed in the following manner on the face of the statement of profit and loss:

Turnover (Gross)	XXXXX
Less: Excise Duty	XXXXX
Turnover (Net)	XXXXX

The amount of excise duty to be shown as deduction from turnover should be the total excise duty for the year except the excise duty related to the difference between the closing stock and opening stock. The excise duty related to the difference between the closing stock and opening stock should be recognised separately in the statement of profit and loss, with an explanatory note in the notes to accounts to explain the nature of the two amounts of excise duty.

9.8 Illustrations

Illustration 1

The stages of production and sale of a producer are as follows (all in Rupees):

Stage	*Activity*	*Costs to date*	*Net Realisable Value*
A	*Raw Materials*	*10,000*	*8,000*
B	*WIP 1*	*12,000*	*13,000*
C	*WIP 2*	*15,000*	*19,000*
D	*Finished Product*	*17,000*	*30,000*
E	*Ready for Sale*	*17,000*	*30,000*
F	*Sale Agreed*	*17,000*	*30,000*
G	*Delivered*	*18,000*	*30,000*
H	*Paid For*	*18,000*	*30,000*

State and explain the stage at which you think revenue will be recognized and how much would be gross profit and net profit on a unit of this product?

Solution

According to AS – 9, sales will be recognized only following two conditions are satisfied:

(i) The sale value is fixed and determinable.

(ii) Property of the goods is transferred to the customer.

Both these conditions are satisfied only at Stage F when sales are agreed upon at a price and goods allocated for delivery purpose.

Gross Profit will be determined at Stage E, when goods are ready for sale after all necessary process for production is over i.e. ₹ 13,000 (30,000 – 17,000).

Net Profit will be determined at Stage H, when goods are delivered and payment collected i.e. ₹ 12,000 (30,000 – 18,000).

Illustration 2

A public sector company is trading gold in India for its customers, after purchasing gold the price of gold is fixed within 120 days as per rules and regulations of Indian Bullion Market by the customer. At the close of year, price of some gold was not fixed on March 31, 2012. The details are given below:

Quantity of Gold	=	*10,000 TT Bars*
Gold Rate as on March 31, 2012	=	*₹ 275 per TT Bar*
Gold Rate was fixed on June 26, 2012 before the finalization of accounts of company	=	*₹ 273 per TT Bar*

Calculate the amount of sales regarding 10,000 TT Bars to be booked in the company's account for the year ended March 31, 2012.

Solution

We need to refer to AS 5 along with AS 9 in this case, since gold is an item which has ready market hence they should be valued at the market price. So, as event occurring after the balance sheet date, the price of gold is fixed at ₹ 273 per TT Bar, gold will be valued at that rate.

Illustration 3

The Board of Directors decided on 31.3.2012 to increase the sale price of certain items retrospectively from 1st January, 2012. In view of this price revision with effect from 1st January 2012, the company has to receive ₹ 15 lakhs from its customers in respect of sales made from 1st January, 2012 to 31st March, 201 and the Accountant cannot make up his mind whether to include ₹ 15 lakhs in the sales for 2011-2012.

Solution

Price revision was effected during the current accounting period 2011-2012. As a result, the company stands to receive ₹ 15 lakhs from its customers in respect of sales made from 1st January, 2012 to 31st March, 2012. If the company is able to assess the ultimate collection with reasonable certainty, then additional revenue arising out of the said price revision may be recognised in 2011-2012 vide Para 10 of AS 9.

Illustration 4

Y Co. Ltd., used certain resources of X Co. Ltd. In return X Co. Ltd. received ₹ 10 lakhs and ₹ 15 lakhs as interest and royalties respective from Y Co. Ltd. during the year 2011-12. You are required to state whether and on what basis these revenues can be recognised by X Co. Ltd.

Solution

As per para 13 of AS 9 on Revenue Recognition, revenue arising from the use by others of enterprise resources yielding interest and royalties should only be recognised when no significant uncertainty as to measurability or collectability exists. These revenues are recognised on the following bases:

(i) Interest: on a time proportion basis taking into account the amount outstanding and the rate applicable.

(ii) Royalties: on an accrual basis in accordance with the terms of the relevant agreement.

Illustration 5

A claim lodged with the Railways in March, 2010 for loss of goods of ₹ 2,00,000 had been passed for payment in March, 2012 for ₹ 1,50,000. No entry was passed in the books of the Company, when the claim was lodged. Advise P Co. Ltd. about the treatment of the following in the Final Statement of Accounts for the year ended 31st March, 2012.

Solution

Prudence suggests non-consideration of claim as an asset in anticipation. So receipt of claims is generally recognised on cash basis. Para 9.2 of AS 9 on Revenue Recognition states that where the ability to assess the ultimate collection with reasonable certainty is lacking at the time of raising any claim, revenue recognition is postponed to the extent of uncertainty involved. Para 9.5 of AS 9 states that when recognition of revenue is postponed due to the effect of uncertainties, it is considered as revenue of the period in which it is properly recognised. In this case it may be assumed that collectability of claim was not certain in the earlier periods. This is supposed from the fact that only ₹ 1,50,000 were collected against a claim of ₹ 2,00,000. So this transaction can not be taken as a Prior Period Item.

In the light of revised AS 5, it will not be treated as extraordinary item. However, para 12 of AS 5 (Revised) states that when items of income and expense within profit or loss from ordinary activities are of such size, nature, or incidence that their disclosure is relevant to explain the performance of the enterprise for the period, the nature and amount of such items should be disclosed separately. Accordingly, the nature and amount of this item should be disclosed separately as per para 12 of AS 5 (Revised).

Illustration 6

SCL Ltd., sells agriculture products to dealers. One of the condition of sale is that interest is payable at the rate of 2% p.m., for delayed payments. Percentage of interest recovery is only 10% on such overdue outstanding due to various reasons. During the year 2011-2012 the company wants to recognise the entire interest receivable. Do you agree?

Solution

As per para 9.2 of AS 9 on Revenue Recognition, where the ability to assess the ultimate collection with reasonable certainty is lacking at the time of raising any claim, e.g. for escalation of price, export incentives, interest etc, revenue recognition is postponed to the extent of uncertainty involved. In such cases, it may be appropriate to recognise revenue only when it is reasonably certain that the ultimate collection will be made. Where there is no uncertainty as to ultimate collection, revenue is recognised at the time of sale or rendering of service even though payments are made by instalments.

Thus, SCL Ltd. cannot recognise the interest amount unless the company actually receives it. 10% rate of recovery on overdue outstandings is also an estimate and is not certain. Hence, the company is advised to recognise interest receivable only on receipt basis.

UNIT 10 : AS 10: ACCOUNTING FOR FIXED ASSETS

Reference: The students are advised to refer the full text of AS 10 “Accounting for Fixed Assets” (issued 1985) given in Appendix I at the end of the Study Material (Volume-II).

10.1 Introduction

The standard deals with the accounting for tangible fixed assets. The standard does not take into consideration the specialized aspect of accounting for fixed assets reflected with the effects of price escalations but applies to financial statements on historical cost basis. It is important to note that after introduction of AS 16, 19 & 26, provisions relating to respective AS are held withdrawn and the rest is mandatory from the accounting year 1-4-2000. An entity should disclose (i) the gross and net book values of fixed assets at beginning and end of an accounting period showing additions, disposals, acquisitions and other movements, (ii) expenditure incurred on account of fixed assets in the course of construction or acquisition, (iii) revalued amounts substituted for historical costs of fixed assets with the method applied in computing the revalued amount.

This statement does not deal with accounting for the following items to which special considerations apply:

(i) Forests, plantations and similar regenerative natural resources.

(ii) Wasting assets including mineral rights, expenditure on the exploration for and extraction of minerals, oil, natural gas and similar non-regenerative resources.

(iii) Expenditure on real estate development and

(iv) Biological assets ie living animals or plants

10.2 Identification of Fixed Assets

Fixed asset is an asset held with the intention of being used for the purpose of producing or providing goods or services and is not held for sale in the normal course of business. Stand-by equipment and servicing equipment are normally capitalised. Machinery spares are usually charged to the profit and loss statement as and when consumed. However, if such spares can be used only in connection with an item of fixed asset, it may be appropriate to allocate the total cost on a systematic basis over a period not exceeding the useful life of the principal item.

10.3 Machinery Spares

Whether to capitalise a machinery spare or not will depend on the facts and circumstances of each case. However, the machinery spares of the following types should be capitalised being of the nature of capital spares/insurance spares -

- Machinery spares which are specific to a particular item of fixed asset, i.e., they can be used only in connection with a particular item of the fixed asset and their use is expected to be irregular.

- Machinery spares of the nature of capital spares/insurance spares should be capitalised separately at the time of their purchase whether procured at the time of purchase of the fixed asset concerned or subsequently. The total cost of such capital spares/insurance spares should be allocated on a systematic basis over a period not exceeding the useful life of the principal item, i.e., the fixed asset to which they relate.
- When the related fixed asset is either discarded or sold, the written down value less disposal value, if any, of the capital spares/insurance spares should be written off.
- The stand-by equipment is a separate fixed asset in its own right and should be depreciated like any other fixed asset.

10.4 Components of Cost

Gross book value of a fixed asset is its historical cost or other amount substituted for historical cost in the books of account or financial statements. When this amount is shown net of accumulated depreciation, it is termed as net book value. The cost of an item of fixed asset comprises

(1) Its purchase price, including import duties and other non-refundable taxes or levies

(2) Any directly attributable cost of bringing the asset to its working condition for its intended use;

(3) The initial estimate of the costs of dismantling and removing the asset and restoring the site on which it is located, the obligation for which the enterprise incurred either when the item was acquired, or as a consequence of having used the asset during a particular period for purposes other than to produce inventories during that period.

Any trade discounts and rebates are deducted in arriving at the purchase price. The cost of a fixed asset may undergo changes subsequent to its acquisition or construction on account of exchange fluctuations, price adjustments and changes in duties or similar factors.

The expenditure incurred on start-up and commissioning of the project, including the expenditure incurred on test runs and experimental production, is usually capitalised as an indirect element of the construction cost. If the interval between the date a project is ready to commence commercial production and the date at which commercial production actually begins is prolonged, all expenses incurred during this period are charged to the profit and loss statement.

10.5 Self-constructed Fixed Assets

The cost of a self-constructed asset is determined using the same principles as for an acquired asset

The Standard states that if an enterprise makes similar assets for sale in the normal course of business, the cost of the asset is usually the same as the cost of constructing the asset for sale, in accordance with the principles of AS 2 Valuation of Inventories.

Administration and other general overhead costs are not a component of the cost of tangible fixed asset because they cannot be directly attributed to the acquisition of the asset or bringing the asset to its working condition.

The following principles also apply:

- any internal profits are eliminated in arriving at the cost of an asset;
- the costs of abnormal amounts of wasted material, labour or other resources incurred in the production of the self-constructed asset are excluded from its cost; and
- borrowing costs incurred during the period of production will be included in accordance with AS 16 'Borrowing Costs' if the self-constructed asset meets the definition of a qualifying asset

Illustration 1

ABC Ltd. is constructing a fixed asset. Following are the expenses incurred on the construction:

Materials	*₹ 10,00,000*
Direct Expenses	*₹ 2,50,000*
Total Direct Labour	*₹ 5,00,000*
(1/10th of the total labour time was chargeable to the construction)	
Total office & administrative expenses	*₹ 8,00,000*
(5% is chargeable to the construction)	
Depreciation on the assets used for the construction of this assets	*₹ 10,000*

Calculate the cost of fixed assets.

Solution

Calculation of the cost of construction of Assets

Particulars	₹
Direct Materials	1,000,000
Direct Labour	50,000
Direct Expenses	250,000
Office & Administrative Expenses	40,000
Depreciation	10,000
Cost of the Asset	1,350,000

10.6 Non-monetary Consideration

When a fixed asset is acquired in exchange for another asset, its cost is usually determined by reference to the fair market value of the consideration given. It may be appropriate to consider also the fair market value of the asset acquired if this is more clearly evident. When a fixed asset is acquired in exchange for shares or other securities in the enterprise, it is usually recorded at its fair market value, or the fair market value of the securities issued, whichever is more clearly evident.

Fair market value is the price that would be agreed to in an open and unrestricted market between knowledgeable and willing parties dealing at arm's length who are fully informed and are not under any compulsion to transact.

10.7 Improvements and Repairs

Any expenditure that increase the future benefits from the existing asset beyond its previously assessed standard of performance is included in the gross book value, e.g., an increase in capacity. A computer with 20GB hard disk crashed and was replaced with a 80GB hard disk, will be capitalised and added to the cost of the computer.The cost of an addition or extension to an existing asset, which has a separate identity and is capable of being used after the existing asset is disposed of, is accounted for separately. Current engine of an aircraft replaced with the new one on being damaged beyond repairs will be treated as a separate asset, as it has its own separate identity.

10.8 Amount Substituted for Historical Cost (Revaluation)

When a tangible fixed asset is revalued, the entire class of tangible fixed assets to which that asset belongs is required to be revalued. Assets within a class of tangible fixed assets are revalued simultaneously to avoid selective revalution of assets and the reporting of amounts in the financial statements that are a mixture of costs and valuations at different dates. This is intended to prevent the distortions caused by selective use of revalution, so as to take credit for gains without acknowledging falls in the value of similar assets.

The revalued amounts of fixed assets are presented in financial statements either by restating both the gross book value and accumulated depreciation so as to give a net book value equal to the net revalued amount or by restating the net book value by adding therein the net increase on account of revaluation. Different bases of valuation are sometimes used in the same financial statements to determine the book value of the separate items within each of the categories of fixed assets or for the different categories of fixed assets. In such cases, it is necessary to disclose the gross book value included on each basis. It is not appropriate for the revaluation of a class of assets to result in the net book value of that class being greater than the recoverable amount of the assets of that class. An increase in net book value arising on revaluation of fixed assets is normally credited directly to owner's interests under the heading of revaluation reserves and is regarded as not available for distribution. Journal entry is as follow:

Fixed Asset Account Dr.

To Revaluation Reserve Account

A decrease in net book value arising on revaluation of fixed assets is charged to profit and loss statement except that, to the extent that such a decrease is considered to be related to a previous increase on revaluation that is included in revaluation reserve.

For example, Journal entry for decrease in the value of the asset on revaluation from ₹ 1,00,000 to ₹ 70,000, if Revaluation Reserve is appearing at ₹ 10,000 will be done as:

Revaluation Reserve Account	Dr.	₹ 10,000	
Loss on Revaluation Account	Dr.	₹ 20,000	
To Fixed Assets Account			₹ 30,000

10.9 Retirements and Disposals (derecognition)

The carrying amount of a tangible fixed asset should be derecognised:

- on disposal; or
- when no future economic benefits are expected from its use or disposal

Items of fixed assets that have been retired from active use and are held for disposal are stated at the lower of their net book value and net realisable value and are shown separately in the financial statements. Any expected loss is recognised immediately in the profit and loss statement. On disposal of a previously revalued item of fixed asset, the difference between net disposal proceeds and the net book value is normally charged or credited to the profit and loss statement except that, to the extent such a loss is related to an increase which was previously recorded as a credit to revaluation reserve and which has not been subsequently reversed or utilised, it is charged directly to that account. The amount standing in revaluation reserve following the retirement or disposal of an asset which relates to that asset may be transferred to general reserve.

For example, the journal entries for the sale of an asset for ₹ 1,00,000 appearing in the books at ₹ 1,15,000, if Revaluation Reserve is appearing at ₹ 20,000 will be as follow:

Bank Account	Dr.	₹ 1,00,000	
Revaluation Reserve Account	Dr.	₹ 15,000	
To Fixed Assets Account			₹ 1,15,000
Revaluation Reserve Account	Dr.	₹ 5,000	
To General Reserve Account			₹ 5,000

10.10 Hire Purchases

In the case of fixed assets acquired on hire purchase terms, although legal ownership does not vest in the enterprise, such assets are recorded at their cash value, which, if not readily available, is calculated by assuming an appropriate rate of interest. They are shown in the balance sheet with an appropriate narration to indicate that the enterprise does not have full ownership thereof.

10.11 Joint Ownership

Where an enterprise owns fixed assets jointly with others, the extent of its share in such assets, and the proportion in the original cost, accumulated depreciation and written down value are stated in the balance sheet. Alternatively, the pro rata cost of such jointly owned assets is grouped together with similar fully owned assets. Details of such jointly owned assets are indicated separately in the fixed assets register.

10.12 Goodwill

Goodwill, in general, is recorded in the books only when some consideration in money or money's worth has been paid for it. As a matter of financial prudence, goodwill is written off over a period. However, many enterprises do not write off goodwill and retain it as an asset.

10.13 Disclosure

(i) Gross and net book values of fixed assets at the beginning and end of an accounting period showing additions, disposals, acquisitions and other movements;

(ii) Expenditure incurred on account of fixed assets in the course of construction or acquisition; and

(iii) Revalued amounts substituted for historical costs of fixed assets, the method adopted to compute the revalued amounts, the nature of any indices used, the year of any appraisal made, and whether an external valuer was involved, in case where fixed assets are stated at revalued amounts.

10.14 Illustrations

Illustration 2

On March 01, 2012, X Ltd. purchased ₹ 5 lakhs worth of land for a factory site. Company demolished an old building on the property and sold the material for ₹ 10,000. Company incurred additional cost and realized salvaged proceeds during the March 2012 as follows:

Legal fees for purchase contract and recording ownership	*₹ 25,000*
Title guarantee insurance	*₹ 10,000*
Cost for demolition of building	*₹ 50,000*

Compute the balance to be shown in the land account on March 31, 2012 balance sheet.

Solution

Calculation of the cost for Purchase of Land

Particulars		₹
Cost of Land		5,00,000
Legal Fees		25,000
Title Insurance		10,000
Cost of Demolition	50,000	
Less: Salvage value of Material	(10,000)	40,000
Cost of the Asset		5,75,000

Illustration 3

(i) T. Ltd. imported fixed assets worth ₹ 1,000 lacs on 1.4.2011, when the exchange rate was ₹ 40 per US $. The assets were fully financed by foreign currency loan repayable in five equal annual installments. As on 31.3.2012, the first installment was paid at the Exchange Rate of ₹ 42.

(ii) The company's fixed assets stood at ₹ 3,000 lacs as on 1.4.2011. It provides depreciation at 10% per annum under the WDV method. However it noticed that about

₹ 500 lacs worth of non-imported assets acquired on 1.4.2011 will be obsolete in 2 years time. It wants to write off these assets over 2 years.

(iii) A few days after the beginning of the year, the company acquired assets for ₹ 500 lacs on which it received a government grant of 10%.

Prepare a schedule as on 31.3.2012 in respect of the above three categories of assets and support the schedule with relevant accounting standards.

Solution

In the Books of T Ltd.

Schedule of Fixed Assets as on 31st March, 2012

(Amount in ₹ lacs)

Fixed Assets	*Gross Block (at cost)*				*Depreciation*				*Net Block*	
	As at 1.4.2011	*Additions*	*Deduction*	*As at 31.3.2012*	*Up to 31.3.2011*	*For the year*	*On Deductions*	*Total upto 31.3.2012*	*As at 31.3.2012*	*As at 31.3.2011*
Imported Assets	–	1,000	–	1,000	–	100	–	100	900	–
Non - Imported Assets (acquired on 1.4.2009)	–	500	–	500	–	250	–	250	250	–
Other Assets	3,000	450	–	3,450	–	345	–	345	3,105	3,000
Total	3,000	1,950	–	4,950	–	695	–	695	4,255	3,000

(1) As per para 13 of AS 11 (Revised 2003) 'The Effects of Changes in Foreign Exchange Rates', exchange differences arising on repayment of liabilities incurred for the purpose of acquiring fixed assets are recognized as income/expense in the period in which they arise.

Calculation of Exchange Difference:

Foreign currency loan $= \dfrac{₹\,1{,}000}{₹\,40}$

= 25 lacs US $

Exchange difference = 25 lacs US $ × (42 – 40)

= ₹ 50 lacs (including exchange loss on payment of first instalment)

Thus, exchange loss of ₹ 50 lakhs should be recognized as expense in the profit and loss account for the year ended 31st March, 2012.

(2) It was noticed that about ₹ 500 lacs worth of non-imported assets acquired on 1.4.2011 will be obsolete in two years time. Hence, these assets have been written off at the rate of 50%.

(3) Para 14 of AS 12 on Accounting for Government Grants regards two methods of presentation of grants related to specific fixed assets in financial statements. Under the first method which has been applied in the given case, the grant is shown as a deduction from the gross value of the fixed assets in arriving at its book value. Thus, only 90% of the cost of fixed assets has been shown as addition after adjusting the grant amount.

Alternatively, the grant can be treated as a deferred income which should be recognised in the profit and loss statement over the useful life of fixed assets in the proportions in which depreciation on the assets will be charged.

Note: As regards fixed assets standing at ₹ 3,000 lacs as on 1.4.2011, in the absence of information in respect of cost and depreciation amount provided upto 31.3.2011, the entire given amount has been shown under gross block as at 1.4.2011.

Illustration 4

J Ltd. purchased machinery from K Ltd. on 30.09.2011. The price was ₹ 370.44 lakhs after charging 8% Sales-tax and giving a trade discount of 2% on the quoted price. Transport charges were 0.25% on the quoted price and installation charges come to 1% on the quoted price.

A loan of ₹ 300 lakhs was taken from the bank on which interest at 15% per annum was to be paid.

Expenditure incurred on the trial run was Materials ₹ 35,000, Wages ₹ 25,000 and Overheads ₹ 15,000.

Machinery was ready for use on 1.12.2011. However, it was actually put to use only on 1.5.2012. Find out the cost of the machine and suggest the accounting treatment for the expenses incurred in the interval between the dates 1.12.2011 to 1.5.2012. The entire loan amount remained unpaid on 1.5.2012.

Solution

(a)	*₹ (in Lakhs)*	*(₹ in Lakhs)*	
Quoted price (refer to working note)	350.00		
Less: 2% Trade Discount	7.00		
	343.00		
Add: 8% Sales tax (8% × ₹ 343 lakhs)	27.44	370.44	
Transport charges (0.25% × ₹ 350 lakhs)		0.88	(approx.)
Installation charges (1% × ₹ 350 lakhs)		3.50	
Financing cost (15% on ₹ 300 Lakhs) for the period 30.9.2011 to 1.12.2011		7.50	
Trial Run Expenses			
Material	0.35		
Wages	0.25		
Overheads	0.15	0.75	
Total cost		383.07	

Interest on loan for the period 1.12.2011 to 1.05.2012 is ₹ 300 lakhs $\times \frac{15}{100} \times \frac{5}{12}$

= ₹ 18.75 lakhs

This expenditure may be charged to Profit and Loss Account or deferred for amortization between say three to five years. It has been assumed that no other expenses are incurred on the machine during this period.

Working Note:

Let the quoted price 'X'

Less: Trade Discount 0.02X.

Actual Price = 0.98X.

Sale Tax @8% = 1.08 × 0.98X

$$= \frac{₹\ 370.44}{108 \times 0.98} = ₹\ 350$$

UNIT 11 : AS 11: THE EFFECTS OF CHANGES IN FOREIGN EXCHANGE RATES

Reference: The students are advised to refer the full text of AS 11 "The Effects of Changes in Foreign Exchange Rates" (revised 2003) given in Appendix I at the end of the Study Material (Volume-II).

11.1 Introduction

AS 11, (revised 2003), comes into effect in respect of accounting periods commencing on or after 1-4-2004 and is mandatory in nature from that date. The standard deals with the issues involved in accounting for foreign currency transactions and foreign operations i.e., to decide which exchange rate to use and how to recognize the financial effects of changes in exchange rates in the financial statements. The standard requires the enterprises to disclose

(i) the amount of exchange differences included in the net profit or loss for the period

(ii) the amount of exchange differences adjusted in the carrying amount of fixed assets,

(iii) the amount of exchange differences in respect of forward exchange contracts to be recognized in the profit or loss in one or more subsequent accounting periods (over the life of the contract).

11.2 Scope

This Statement should be applied:

(a) In accounting for transactions in foreign currencies.

(b) In translating the financial statements of foreign operations.

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

This Statement does not:

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

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

(c) Deal with exchange differences arising from foreign currency borrowings to the extent that they are regarded as an adjustment to interest costs.

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

11.3 Definitions of the terms used in the Standard

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

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

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

(c) Becomes a party to an unperformed forward exchange contract or

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

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

Non-monetary items are assets and liabilities other than monetary items. For example, fixed assets, inventories and investments in equity shares.

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

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

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

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

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

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

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

11.4 Initial Recognition

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

A rate that approximates the actual rate at the date of the transaction is often used, for example, an average rate for a week or a month might be used for all transactions in each foreign currency occurring during that period. However, if exchange rates fluctuate significantly, the use of the average rate for a period is unreliable.

11.5 Reporting at each balance sheet date

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

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

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

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

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

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

11.6 Recognition of Exchange Differences

Exchange differences arise on:

- the settlement of monetary items at a date subsequent to intial recognition; and
- remeasuring an enterprise's monetary items at rates different from those at which they were either initially recorded (if in the period) or previously recorded (at the previous balance sheet date).

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

11.7 Classification of Foreign Operations as Integral or Non-integral

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

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

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

11.7 Translation of Foreign Integral Operations

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

11.8 Translation of Non-Integral Foreign Integral Operations

The translation of the financial statements of a non-integral foreign operation is done using the 'closing rate method' in which the following procedures are used:

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

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

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

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

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

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

(g) The incorporation of the financial statements of a non-integral foreign operation in those of the reporting enterprise follows normal consolidation procedures, such as the elimination of intra-group balances and intra-group transactions of a subsidiary (AS 21 and AS 27). However, an exchange difference arising on an intra-group monetary item, whether short-term or long-term, cannot be eliminated against a corresponding amount arising on other intra-group balances because the monetary item represents a commitment to convert one currency into another and exposes the reporting enterprise to a gain or loss through currency fluctuations.

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

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

(j) An enterprise may dispose of its interest in a non-integral foreign operation through sale, liquidation, repayment of share capital, or abandonment of all, or part of, that operation. The payment of a dividend forms part of a disposal only when it constitutes a return of the investment. In the case of a partial disposal, only the proportionate share of the related accumulated exchange differences is included in the gain or loss. A write-down of the carrying amount of a non-integral foreign operation does not constitute a partial disposal. Accordingly, no part of the deferred foreign exchange gain or loss is recognised at the time of a write-down.

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

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

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

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

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

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

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

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

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

11.9 Change in the Classification of a Foreign Operation

When a foreign operation that is integral to the operations of the reporting enterprise is reclassified as a non-integral foreign operation, exchange differences arising on the translation of non-monetary assets at the date of the reclassification are accumulated in a foreign currency translation reserve.

When a non-integral foreign operation is reclassified as an integral foreign operation, the translated amounts for non-monetary items at the date of the change are treated as the historical cost for those items in the period of change and subsequent periods. Exchange differences which have been deferred are not recognised as income or expenses until the disposal of the operation.

11.10 Tax Effects of Exchange Differences

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

11.11 Forward exchange contract

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

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

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

Illustration 1

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

Solution

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

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

11.12 Disclosure

An enterprise should disclose:

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

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

When the reporting currency is different from the currency of the country in which the enterprise is domiciled, the reason for using a different currency should be disclosed. The reason for any change in the reporting currency should also be disclosed.

When there is a change in the classification of a significant foreign operation, an enterprise should disclose:

(a) The nature of the change in classification;

(b) The reason for the change;

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

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

11.13 Miscellaneous Illustrations

Illustration 2

A Ltd. purchased fixed assets costing ₹ 3,000 lakhs on 1.1.2011 and the same was fully financed by foreign currency loan (U.S. Dollars) payable in three annual equal instalments. Exchange rates were 1 Dollar = ₹ 40.00 and ₹ 42.50 as on 1.1.2011 and 31.12.2011 respectively. First instalment was paid on 31.12.2011. The entire difference in foreign exchange has been capitalized.

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

Solution

As per para 13 of AS 11 (Revised 2003) 'The Effects of Changes in Foreign Exchange Rates', exchange differences arising on the settlement of monetary items or on reporting an enterprise's monetary items at rates different from those at which they were initially recorded during the period, or reported in previous financial statements, should be recognized as income or expenses in the period in which they arise. Thus exchange differences arising on repayment of liabilities incurred for the purpose of acquiring fixed assets are recognized as income or expense.

Calculation of Exchange Difference:

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

Exchange difference = 75 lakhs US Dollars ´ (42.50 – 40.00)

= ₹ 187.50 lakhs

(including exchange loss on payment of first instalment)

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

Illustration 3

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

Solution

The financial statements of an integral foreign operation (for example, dependent foreign branches) should be translated using the principles and procedures described in paragraphs 8 to 16 of AS 11 (Revised 2003). The individual items in the financial statements of a foreign operation are translated as if all its transactions had been entered into by the reporting enterprise itself.

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

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

Thus, the treatment by the management of translating all assets and liabilities; income and expenditure items in respect of foreign branches at the prevailing rate at the year end and also the treatment of resultant exchange difference is not in consonance with AS 11 (Revised 2003).

Note: For the purpose of translation of assets, liabilities, income and expenditure items of foreign operations, AS 11 (Revised 2003) classifies the foreign operation into two types – Integral foreign operation, Non-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 operation is a foreign operation that is not an integral foreign operation. The above answer has been given on the basis that the foreign branches referred in the question are integral foreign operations.

UNIT 12 : AS 12: ACCOUNTING FOR GOVERNMENT GRANTS

Reference: The students are advised to refer the full text of AS 12 "Accounting for Government Grants" (issued 1991) given in Appendix I at the end of the Study Material (Volume-II)..

12.1 Introduction

The Standard comes into effect in respect of accounting periods commencing on or after 1.4.1992 and will be recommendatory in nature for an initial period of two years. AS 12 deals with accounting for government grants like subsidies, cash incentives, duty drawbacks, etc. and specifies that the government grants should not be recognized until there is reasonable assurance that the enterprise will comply with the conditions attached to them, and the grant will be received. The standard also describes the treatment of non-monetary government grants; presentation of grants related to specific fixed assets, related to revenue, related to promoters' contribution; treatment for refund of government grants etc. The enterprises are required to disclose

(i) the accounting policy adopted for government grants including the methods of presentation in the financial statements;

(ii) the nature and extent of government grants recognized in the financial statements, including non-monetary grants of assets given either at a concessional rate or free of cost.

This Statement does not deal with:

(i) The special problems arising in accounting for government grants in financial statements reflecting the effects of changing prices or in supplementary information of a similar nature.

(ii) Government assistance other than in the form of government grants.

(iii) Government participation in the ownership of the enterprise.

The receipt of government grants by an enterprise is significant for preparation of the financial statements for two reasons. Firstly, if a government grant has been received, an appropriate method of accounting therefore is necessary. Secondly, it is desirable to give an indication of the extent to which the enterprise has benefited from such grant during the reporting period. This facilitates comparison of an enterprise's financial statements with those of prior periods and with those of other enterprises.

12.2 Accounting Treatment of Govternment Grants

Two broad approaches may be followed for the accounting treatment of government grants:

- the 'capital approach', under which a grant is treated as part of shareholders' funds, and
- the 'income approach', under which a grant is taken to income over one or more periods.

Those in support of the **'capital approach'** argue as follows:

(i) Many government grants are in the nature of promoters' contribution, i.e., they are given by way of contribution towards its total capital outlay and no repayment is ordinarily expected in the case of such grants.

(ii) They are not earned but represent an incentive provided by government without related costs.

Arguments in support of the **'income approach'** are as follows:

(i) The enterprise earns grants through compliance with their conditions and meeting the envisaged obligations. They should therefore be taken to income and matched with the associated costs which the grant is intended to compensate.

(ii) As income tax and other taxes are charges against income, it is logical to deal also with government grants, which are an extension of fiscal policies, in the profit and loss statement.

(iii) In case grants are credited to shareholders' funds, no correlation is done between the accounting treatment of the grant and the accounting treatment of the expenditure to which the grant relates.

It is generally considered appropriate that accounting for government grant should be based on the nature of the relevant grant. Grants which have the characteristics similar to those of promoters' contribution should be treated as part of shareholders' funds. Income approach may be more appropriate in the case of other grants.

12.3 Recognition of Government Grants

A government grant is not recognised until there is reasonable assurance that:

- the enterprise will comply with the conditions attaching to it; and
- the grant will be received.

Receipt of a grant is not of itself conclusive evidence that the conditions attaching to the grant have been or will be fulfilled.

12.4 Non-monetary Government Grants

Government grants may take the form of non-monetary assets, such as land or other resources, given at concessional rates. In these circumstances, it is usual to account for such assets at their acquisition cost. Non-monetary assets given free of cost are recorded at a nominal value.

12.5 Presentation of Grants Related to Specific Fixed Assets

Two methods of presentation in financial statements of grants related to specific fixed assets are regarded as acceptable alternatives.

Under one method, the grant is shown as a deduction from the gross value of the asset concerned in arriving at its book value. The grant is thus recognised in the profit and loss statement over the useful life of a depreciable asset by way of a reduced depreciation charge. Where the grant equals the whole, or virtually the whole, of the cost of the asset, the asset is shown in the balance sheet at a nominal value.

Under the other method, grants related to depreciable assets are treated as deferred income which is recognised in the profit and loss statement on a systematic and rational basis over the useful life of the asset.

Grants related to non-depreciable assets are credited to capital reserve under this method, as there is usually no charge to income in respect of such assets. However, if a grant related to a non-depreciable asset requires the fulfillment of certain obligations, the grant is credited to income over the same period over which the cost of meeting such obligations is charged to income. The deferred income is suitably disclosed in the balance sheet after 'Reserves and Surplus' but before 'Secured Loans' with a suitable description, e.g., 'Deferred government grants'.

12.6 Presentation of Grants Related to Revenue

AS 12 permits two methods of presentation in the financial statements for grants related to income:

1. directly as a credit to the statement of profit and loss, either separately or under a general heading such as 'other income'; or
2. as a deduction in reporting the related expense.

12.7 Presentation of Grants of the nature of Promoters' contribution

Where the government grants are of the nature of promoters' contribution, the grants are treated as capital reserve which can be neither distributed as dividend nor considered as deferred income.

12.8 Refund of Government Grants

Government grants sometimes become refundable because certain conditions are not fulfilled and is treated as an extraordinary item (AS 5).

The amount refundable in respect of a government grant related to revenue is applied first against any unamortised deferred credit remaining in respect of the grant. To the extent that the amount refundable exceeds any such deferred credit, or where no deferred credit exists, the amount is charged immediately to profit and loss statement.

The amount refundable in respect of a government grant related to a specific fixed asset is recorded by increasing the book value of the asset or by reducing the capital reserve or the deferred income balance, as appropriate, by the amount refundable.

Where a grant which is in the nature of promoters' contribution becomes refundable, in part or in full, to the government on non-fulfillment of some specified conditions, the relevant amount recoverable by the government is reduced from the capital reserve.

12.9 Disclosure

(i) The accounting policy adopted for government grants, including the methods of presentation in the financial statements;

(ii) The nature and extent of government grants recognised in the financial statements, including grants of non-monetary assets given at a concessional rate or free of cost.

12.10 Miscellaneous Illustrations

Illustration 1

Sagar Limited belongs to the engineering industry. The Chief Accountant has prepared the draft accounts for the year ended 31.03.2012. You are required to advise the company on the following item from the viewpoint of finalisation of accounts, taking note of the mandatory accounting standards:

The company purchased on 01.04.2011 special purpose machinery for ₹ 25 lakhs. It received a Central Government Grant for 20% of the price. The machine has an effective life of 10 years.

Solution

AS 12 'Accounting for Government Grants' regards two methods of presentation, of grants related to specific fixed assets, in financial statements as acceptable alternatives. Under the first method, the grant can be shown as a deduction from the gross book value of the machinery in arriving at its book value. The grant is thus recognised in the profit and loss statement over the useful life of a depreciable asset by way of a reduced depreciation charge.

Under the second method, it can be treated as deferred income which should be recognised in the profit and loss statement over the useful life of 10 years in the proportions in which depreciation on machinery will be charged. The deferred income pending its apportionment to profit and loss account should be disclosed in the balance sheet with a suitable description e.g., 'Deferred government grants' to be shown after 'Reserves and Surplus' but before 'Secured Loans'.

The following should also be disclosed:

(i) the accounting policy adopted for government grants, including the methods of presentation in the financial statements;

(ii) the nature and extent of government grants recognised in the financial statement of ₹ 6 lakhs is required to be credited to the profit and loss statement of the current year.

Illustration 2

Top & Top Limited has set up its business in a designated backward area which entitles the company to receive from the Government of India a subsidy of 20% of the cost of investment. Having fulfilled all the conditions under the scheme, the company on its investment of ₹ 50 crore in capital assets, received ₹ 10 crore from the Government in January, 2012 (accounting period being 2011-2012). The company wants to treat this receipt as an item of revenue and thereby reduce the losses on profit and loss account for the year ended 31st March, 2012.

Keeping in view the relevant Accounting Standard, discuss whether this action is justified or not.

Solution

As per para 10 of AS 12 'Accounting for Government Grants', where the government grants are of the nature of promoters' contribution, i.e. they are given with reference to the total investment in an undertaking or by way of contribution towards its total capital outlay (for example, central investment subsidy scheme) and no repayment is ordinarily expected in respect thereof, the grants are treated as capital reserve which can be neither distributed as dividend nor considered as deferred income.

In the given case, the subsidy received is neither in relation to specific fixed asset nor in relation to revenue. Thus it is inappropriate to recognise government grants in the profit and loss statement, since they are not earned but represent an incentive provided by government without related costs. The correct treatment is to credit the subsidy to capital reserve. Therefore, the accounting treatment followed by the company is not proper.

Illustration 3

On 1.4.2009, ABC Ltd. received Government grant of ₹ 300 lakhs for acquisition of a machinery costing ₹ 1,500 lakhs. The grant was credited to the cost of the asset. The life of the machinery is 5 years. The machinery is depreciated at 20% on WDV basis. The Company had to refund the grant in May 2012 due to non-fulfillment of certain conditions.

How you would deal with the refund of grant in the books of ABC Ltd.?

Solution

According to para 21 of AS 12 on Accounting for Government Grants, the amount refundable in respect of a grant related to a specific fixed asset should be recorded by increasing the book value of the asset or by reducing the capital reserve or deferred income balance, as appropriate, by the amount refundable. In the first alternative, i.e., where the book value is increased, depreciation on the revised book value should be provided prospectively over the residual useful life of the asset. The accounting treatment in both the alternatives can be given as follows:

Alternative 1:

		₹ (in lakhs)
1st April, 2009	Acquisition cost of machinery (₹ 1,500 – ₹ 300)	1,200.00
31st March, 2010	*Less*: Depreciation @ 20%	(240.00)
	Book value	960.00
31st March, 2011	*Less*: Depreciation @ 20%	(192.00)
	Book value	768.00
31st March, 2012	*Less*: Depreciation @ 20%	(153.60)
1st April, 2012	Book value	614.40
May, 2012	*Add*: Refund of grant	300.00
	Revised book value	914.40

Depreciation @ 20% on the revised book value amounting ₹ 914.40 lakhs is to be provided prospectively over the residual useful life of the asset i.e. years ended 31st March, 2013 and 31st March, 2014.

Alternative 2:

ABC Ltd. can also debit the refund amount of ₹ 300 lakhs in capital reserve of the company.

UNIT 13 : AS:13 ACCOUNTING FOR INVESTMENTS

Reference: The students are advised to refer the full text of AS 13 "Accounting for Investments" (issued 1993) given in Appendix I at the end of the Study Material (Volume-II).

13.1 Introduction

This Accounting Standard comes into effect for financial statements covering periods commencing on or after April 1, 1995. The statement deals with accounting for investments in the financial statements of enterprises and related disclosure requirements. The enterprises are required to disclose the current investments (realizable in nature and intended to be held for not more than one year from the date of its acquisition) and long terms investments (other than current investments) distinctly in their financial statements. An investment property should be accounted for as long-term investments. The cost of investments should include all acquisition costs (including brokerage, fees and duties) and on disposal of an investment, the difference between the carrying amount and net disposal proceeds should be charged or credited to profit and loss statement.

This Statement does not deal with:

a. The basis for recognition of interest, dividends and rentals earned on investments which are covered by AS 9.
b. Operating or finance leases.
c. Investments on retirement benefit plans and life insurance enterprises and
d. Mutual funds and/or the related asset management companies, banks and public financial institutions formed under a Central or State Government Act or so declared under the Companies Act, 1956.

13.2 Definition of the terms used in the Standard

Investments are assets held by an enterprise for earning income by way of dividends, interest, and rentals, for capital appreciation, or for other benefits to the investing enterprise. Assets held as stock-in-trade are not 'investments'

Fair value is the amount for which an asset could be exchanged between a knowledgeable, willing buyer and a knowledgeable, willing seller in an arm's length transaction. Under appropriate circumstances, market value or net realisable value provides an evidence of fair value.

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

13.3 Forms of Investments

Enterprises hold investments for diverse reasons. For some enterprises, investment activity is a significant element of operations, and assessment of the performance of the enterprise may largely, or solely, depend on the reported results of this activity.Some investments have no physical existence and are represented merely by certificates or similar documents (e.g., shares) while others exist in a physical form (e.g., buildings).For some investments, an active market exists from which a market value can be established. For other investments, an active market does not exist and other means are used to determine fair value.

13.4 Classification of Investments

A current investment is an investment that is by its nature readily realisable and is intended to be held for not more than one year from the date on which such investment is made. The intention to hold for not more than one year is to be judged at the time of purchase of investment.

A **long term investment** is an investment other than a current investment.

13.5 Cost of Investments

The cost of an investment includes acquisition charges such as brokerage, fees and duties etc.If an investment is acquired, or partly acquired, by the issue of shares or other securities or another assets, the acquisition cost is the fair value of the securities issued or assets given up. The fair value may not necessarily be equal to the nominal or par value of the securities issued. It may be appropriate to consider the fair value of the investment acquired if it is more clearly evident.

Interest, dividends and rentals receivables in connection with an investment are generally regarded as income, being the return on the investment. However, in some circumstances, such inflows represent a recovery of cost and do not form part of income. If it is difficult to make such an allocation except on an arbitrary basis, the cost of investment is normally reduced by dividends receivable only if they clearly represent a recovery of a part of the cost.

When right shares offered are subscribed for, the cost of the right shares is added to the carrying amount of the original holding. If rights are not subscribed for but are sold in the market, the sale proceeds are taken to the profit and loss statement. However, where the investments are acquired on cum-right basis and the market value of investments immediately after their becoming ex-right is lower than the cost for which they were acquired, it may be appropriate to apply the sale proceeds of rights to reduce the carrying amount of such investments to the market value.

13.6 Carrying Amount of Investments

The carrying amount for current investments is the lower of cost and fair value.

Any reduction in realisable value is debited to profit and loss account, however if realisable value of investment is increased subsequently, the increase in value of current investment to the level of the cost is credited to profit and loss account.

Long-term investments are usually carried at cost. Where there is a decline, other than temporary, in the carrying amounts of long term valued investments, the resultant reduction in the carrying amount is charged to the profit and loss statement. The reduction in carrying amount is reversed when there is a rise in the value of the investment, or if the reasons for the reduction no longer exist.

13.7 Investment Properties

An **investment property** is an investment in land or buildings that are not intended to be occupied substantially for use by, or in the operations of, the investing enterprise. The cost of any shares in a co-operative society or a company, the holding of which is directly related to the right to hold the investment property, is added to the carrying amount of the investment property.

13.8 Disposal of Investments

On disposal of an investment, the difference between the carrying amount and the disposal proceeds, net of expenses, is recognised in the profit and loss statement. When disposing of a part of the holding of an individual investment, the carrying amount to be allocated to that part is to be determined on the basis of the average carrying amount of the total holding of the investment.

13.9 Reclassification of Investments

Where long-term investments are reclassified as current investments, transfers are made at the lower of cost and carrying amount at the date of transfer.

Where investments are reclassified from current to long-term, transfers are made at the lower of cost and fair value at the date of transfer.

13.10 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:
   i. Interest, dividends (showing separately dividends from subsidiary companies), and rentals on investments showing separately such income from long term and current investments. Gross income should be stated, the amount of income tax deducted at source being included under Advance Taxes Paid.
   ii. Profits and losses on disposal of current investments and changes in carrying amount of such investments.
   iii. Profits and losses on disposal of long term investments and changes in the carrying amount of such investments.
c. Significant restrictions on the right of ownership, realisability of investments or the remittance of income and proceeds of disposal.
d. The aggregate amount of quoted and unquoted securities separately.
e. Other disclosures as specifically required by the relevant statute governing the enterprise.

Illustration 1

An unquoted long term investment is carried in the books at a cost of ₹ 2 lakhs. The published accounts of the unlisted company received in May, 2012 showed that the company was incurring cash losses with declining market share and the long term investment may not fetch more than ₹ 20,000. How will you deal with this in preparing the financial statements of R Ltd. for the year ended 31st March, 2012?

Solution

As it is stated in the question that financial statements for the year ended 31st March, 2012 are under preparation, the views have been given on the basis that the financial statements are yet to be completed and approved by the Board of Directors.

Investments classified as long term investments should be carried in the financial statements at cost. However, provision for diminution shall be made to recognise a decline, other than temporary, in the value of the investments, such reduction being determined and made for each investment individually. Para 17 of AS 13 'Accounting for Investments' states that indicators of the value of an investment are obtained by reference to its market value, the investee's assets and results and the expected cash flows from the investment. On these bases, the facts of the given case clearly suggest that the provision for diminution should be made to reduce the carrying amount of long term investment to ₹ 20,000 in the financial statements for the year ended 31st March, 2012.