REVISIONARY TEST PAPER

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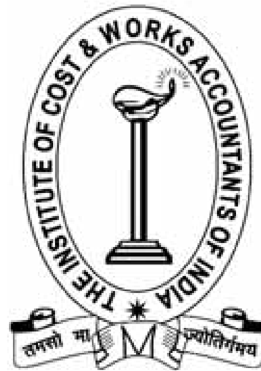
GROUP IV

PAPER - 16 : ADVANCED FINANCIAL ACCOUNTING & REPORTING



THE INSTITUTE OF
COST AND WORKS ACCOUNTANTS OF INDIA

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FINAL EXAMINATION

(REVISED SYLLABUS - 2008)

GROUP - IV

Paper-16 : ADVANCED FINANCIAL ACCOUNTING & REPORTING

Q1. Write short notes on the Advantages and disadvantages of setting of Accounting Standards.

Answer 1.

The 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. The ostensible purpose of the standard setting bodies is to promote the dissemination of timely and useful financial information to investors and certain other parties having an interest in companies' economic performance. The setting of accounting standards has the following advantages:

(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 practised in different countries.

However, there are some **disadvantages** 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.

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

Q2. (a) Briefly indicate the items, which are included in the expression "borrowing cost" as explained in AS 16.

(b) Explain the difference between direct and indirect methods of reporting cash flows from operating activities with reference to Accounting Standard 3(AS 3) revised.

(c) Write short note on Effect of Uncertainties on Revenue Recognition.

Answer 2.

(a) Borrowing costs: Borrowing costs are interest and other costs incurred by an enterprise in connection with the borrowing of funds.

As per para 4 of AS 16 on Borrowing Costs, borrowing costs may include :

(i) Interest and commitment charges on bank borrowings and other short-term and long-term borrowings;

(ii) Amortization of discounts or premiums relating to borrowings ;

(iii) Amortization of ancillary costs incurred in connection with the arrangement of borrowings;

(iv) Finance charges in respect of assets acquired under finance leases or under other similar arrangements; and

(v) Exchange differences arising from foreign currency borrowings to the extent that they are regarded as an adjustment to interest costs.

(b) As per para 18 of AS 3 (Revised) on Cash Flow Statements, an enterprise should report cash flows from operating activities using either:

(i) The direct method whereby major classes of gross cash receipts and gross cash payments are disclosed; or

(ii) The indirect method, whereby net profit or loss is adjusted for the effects of transactions of a non-cash nature, any deferrals or accruals of past or future operating cash receipts or payments, and items of income or expense associated with investing or financing cash flows.

The direct method provides information which may be useful in estimating future cash flows and which is not available under the indirect method and is, therefore, considered more appropriate than the indirect method. Under the direct method, information about major classes of gross cash receipts and gross cash payments may be obtained either:

(a) from the accounting records of the enterprise; or

(b) by adjusting sales, cost of sales (interest and similar income and interest expense and similar charges for a financial enterprise) and other items in the statement of profit and loss for:

(i) changes during the period in inventories and operating receivables and payables:

(ii) other non-cash items; and

(iii) other items for which the cash effects are investing or financing cash flows.

Under the indirect method, the net cash flow from operating activities is determined by adjusting net profit or loss for the effects of:

(i) changes during the period in inventories and operating receivables and payables;

(ii) non-cash items such as depreciation, provisions, deferred taxes, and unrealized foreign exchange gains and losses; and

(iii) all other items for which the cash effects are investing or financing cash flows.

Alternatively, the net cash flow from operating activities may be presented under the indirect method by showing the operating revenues and expenses, excluding non-cash items disclosed in the statement of profit and loss and the changes during the period in inventories and operating receivables and payables.

(c) **Effect of Uncertainties on Revenue Recognition**

Para 9 of AS 9 on "Revenue Recognition" deals with the effect of uncertainties on Revenue Recognition. The para states:

(i) Recognition of revenue requires that revenue is measurable and at the time of sale or the rendering of the service it would not be unreasonable to expect ultimate collection.

(ii) 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. When there is uncertainty as to ultimate collection, revenue is recognised at the, time of sale or rendering of service even, though payments are made by instalments.

(iii) When the uncertainty relating to collectability arises subsequent to the time of sale or 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.

(iv) An essential criterion for the recognition of revenue is that the consideration receiv-able 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.

(v) 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.

Q3. Sagar Limited belongs to the engineering industry. The Chief Accountant has prepared the draft accounts for the year ended 31.03.09. You are required to advise the company on the following items from the viewpoint of finalisation of accounts, taking note of the mandatory accounting standards.

(a) An audit stock verification during the year revealed that the opening stock of the year was understated by Rs. 3 lakhs due to wrong counting.

(b) The company purchased on 01.04.08 a special purpose machinery for Rs. 25 lakhs. It received a Central Government Grant for 20% of the price. The machine has an effective life of 10 years.

(c) The company undertook a contract for building a crane for Rs. 10 lakhs. As on 31.03.09 it incurred a cost of Rs. 1.5 lakhs and expects that there will be Rs. 9 lakhs more for completing the crane. It has received so far Rs. 1 lakh as progress payment.

Answer 3.

(a) The wrong counting of opening stock of the current year/closing stock of the previous year must have also resulted in lowering of profits of previous year, brought forward to the current year. The adjustments are required to be made in the current year in respect of these errors in the preparation of the financial statements of the prior period and should therefore be treated as prior period adjustments as per AS 5 (Revised). Accordingly, the rectifications relating to both opening stock of the current year and profit brought forward from the previous year should be separately disclosed in the current statement of profit and loss together with their nature and amount in a manner that their impact on current profit or loss can be perceived.

(b) 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 recog-nised 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.

(c) Para 21 of AS 7 (Revised) 'Construction Contracts' provides that when the outcome of a construction contract can be estimated reliably, contract revenue and contract costs associated with the construction contract should be recognized as revenue and expenses respectively with reference to the stage of completion of the contract activity at the reporting date.

As per para 32 of the standard, during the early stages of a contact 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 recognized 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. Para 35 of the standard states that when it is probable that the total contacts costs will exceed total contract revenue, the expected loss should be recognised as an expense immediately. Thus the forseesable loss of Rs. 50,000 (expected cost Rs. 10.5 lakhs less contract revenue Rs. 10 lakhs) should be recognized as an expense in the year ended 31st March, 2009.

Also, the following disclosures should be given in the financial statements:

(i) The amount of contract revenue recognized as revenue in the period;

(ii) The aggregate amount of costs incurred and loss recognized upto the reporting date;

(iii) Amount of advances received;

(iv) Amount of retentions; and

(v) Gross amount due from/due to customers Amount*

Q4. A firm of contractors obtained a contract for construction of bridges across river Mahanadi. The following details are available in the records kept for the year ended 31st March, 2009.

	(Rs. 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 ICAI.

Answer 4.

(a) Amount of foreseeable loss

	(Rs 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 Rs. 605 lakhs

	(Rs 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 Rs. 1,000 lakhs = Rs. 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)] Rs. in lakhs

= [605 – 100 – 540] Rs. in lakhs

Amount due to customers = Rs. 35 lakhs

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

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

	Rs. 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

Q5. In preparing the financial statements of R Ltd. for the year ended 31st March, 2009, you come across the following information. State with reasons, how you would deal with them in the financial statements :

(a) An unquoted long term investment is carried in the books at a cost of Rs. 2 lakhs. The published accounts of the unlisted company received in May, 2009 showed that the company was incurring cash losses with declining market share and the long term investment may not fetch more than Rs. 20,000.

(b) The company invested 100 lakhs in April, 2009 in the acquisition of another company doing similar business, the negotiations for which had started during the financial year.

(c) There was a major theft of stores valued at Rs. 10 lakhs in the preceding year which was detected only during current financial year (2008-09).

As it is stated in the question that financial statements for the year ended 31st March, 2009 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.

Answer5.

(a) 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 Rs. 20,000 in the financial statements for the year ended 31st March, 2009.

(b) 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, 2009. 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 Rs. 100 lakhs in April, 2009 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.

(c) Due to major theft of stores in the preceding year (2007-08) which was detected only during the current financial year (2008-09), 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, 2009.

Q6. (a) A Limited Company closed its accounting year on 30.6.09 and the accounts for that period were considered and approved by the board of directors on 20th August, 2009. The company was engaged in laying pipe line for an oil company deep beneath the earth. While doing the boring work on 1.9.2009 it had met a rocky surface for which it was estimated that there would be an extra cost to the tune of Rs. 80 lakhs. You are required to state with reasons, how the event would be dealt with in the financial statements for the year ended 30.6.09.

(b) X Co. Ltd., has obtained an Institutional Loan of Rs. 680 lakhs for modernisation and renovation of its plant & machinery, Plant & machinery acquired under the modernisation scheme and installation completed on 31.3.09 amounted to Rs. 520 lakhs, 30 lakhs has been advanced to suppliers for additional assets and the balance loan of Rs. 130 lakhs has been utilized for working capital purpose. The total interest paid for the above loan amounted to Rs. 62 lakhs during 2008-09.

You are required to state how the interest on the institutional loan is to be accounted for in the year 2008-09.

(c) Y Co. Ltd., used certain resources of X Co. Ltd. In return X Co. Ltd. received Rs. 10 lakhs and Rs. 15 lakhs as interest and royalties respective from Y Co. Ltd. during the year 2008-2009.

You are required to state whether and on what basis these revenues can be recognised by X Co. Ltd.

(d) A Ltd. purchased fixed assets costing Rs. 3,000 lakhs on 1.1.09 and the same was fully financed by foreign currency loan (U.S. Dollars) payable in three annual equal instalments. Exchange rates were 1 Dollar = Rs. 40.00 and Rs. 42.50 as on 1.1.09 and 31.12.09 respectively. First instalment was paid on 31.12.09. The entire difference in foreign exchange has been capitalized.

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

(e) A Limited Company finds that the stock sheets as on 31.3.08 had included twice an item the cost of which was Rs. 20,000.

You are asked to suggest, how the error would be dealt with in the accounts of the year ended 31.3.09

Answer 6.

(a) 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.

(b) The treatment for total interest amount of Rs. 68 lakhs can be given as follows :

Purpose	Nature	Interest to be capitalized	Interest to be charged to profit and loss account
		Rs. in lakhs	Rs. in lakhs
Modernisation and renovation of plant and machinery	Qualifying asset*		
Advance to suppliers for additional assets	Qualifying asset*	$\frac{62 \times 30}{680} = 2.74$	
Working Capital	Not a qualifying asset		$\frac{62 \times 130}{680} = 11.85$
		50.15	11.85

(c) 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.

(d) 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 :

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

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

= Rs. 187.50 lakhs

(including exchange loss on payment of first instalment)

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

(e) The error in the recording of closing stock of the year ended 31st March, 2008 must have also resulted in overstatement of profits of previous year, brought forward to the current year ended 31st March, 2009. Vide para 4 of AS 5 (Revised) on Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies, the rectifications as required in the current year are 'Prior Period Items'. Accordingly, Rs. 20,000 should be deducted from opening stock in the profit and loss account. And Rs. 20,000 should be charged as prior period adjustment in the profit and loss account for the year ended 31st March 2009 in accordance with para 15 of AS 5 (Revised) which requires that the nature and amount of prior period items should be separately disclosed in the statement of profit and loss in a manner that their impact on the current profit or loss can be perceived.

Q7. (i) Advise P Co. Ltd. about the treatment of the following in the Final Statement of Accounts for the year ended 31st March, 2009.

A claim lodged with the Railways in March, 2006 for loss of goods of Rs. 2,00,000 had been passed for payment in March, 2009 for Rs. 1,50,000. No entry was passed in the books of the Company, when the claim was lodged.

(ii) The notes to accounts of X Ltd. for the year 2008-09 include the following :

"Interest on bridge loan from banks and Financial Institutions and on Debentures specifically obtained for the Company's Fertiliser Project amounting to Rs. 1,80,80,000 has been capitalized during the year, which includes approximately Rs. 1,70,33,465 capitalised in respect of the utilization of loan and debenture money for the said purpose." Is the treatment correct? Briefly comment.

Answer 7.

(i) 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 Recog-nition 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 Rs. 1,50,000 were collected against a claim of Rs. 2,00,000. So this transaction cannot 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).

(ii) The treatment done by the company is not in accordance with AS 16 'Borrowing Costs'. As per para 10 of AS 16, to the extent that funds are borrowed specifically for the purpose of obtaining a qualifying asset, the amount of borrowing costs eligible for capitalisation on that asset should be determined as the actual borrowing costs incurred on that borrowing during the period. Hence, the capitalisation of borrowing costs should be restricted to the actual amount of interest expenditure i.e. Rs. 1,70,33,465. Thus, there is an excess capitalisation of Rs. 10,46,535. This has resulted in overstatement of profits by Rs. 10,46,535 and amount of fixed assets has also gone up by this amount.

Q8. State with reference to accounting standard, how will you value the inventories in the following cases :

(i) Raw material was purchased at Rs. 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 Rs. 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 Rs. 1,000. The entire quantity of waste is on stock at the year end.

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

Material cost Rs. 100 per kg.

Direct labour cost Rs. 20 per kg.

Direct variable production overhead Rs. 10 per kg.

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

Answer 8.

(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 Rs. 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 Rs. 50,000 (50 MT x Rs. 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 :

	Rs.
Material cost	100
Direct labour cost	20
Direct variable production overhead	10
Fixed production overhead	10
$\left(\frac{\text{Rs. } 10,00,000}{1,00,000}\right)$	
	140

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

Q9. From the following Summary Cash Account of X Ltd. prepare Cash Flow Statement for the year ended 31st March, 2009 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 31.3.2009.

	Rs. '000		**Rs. '000**
Balance on 1.4.2008	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 31.3.2009	150
	3,250		3,250

Answer 9.

X Ltd.
Cash Flow Statement for the year ended 31st March, 2009
(Using the direct method)

	Rs. '000	Rs. '000
Cash flows from operating activities		
Cash receipts from customers	2,800	
Cash payment 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		
Payment 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

Q10. Answer the following questions by quoting the relevant Accounting Standard :

(i) During the year 2008-2009, a medium size manufacturing company wrote down its inventories to net realisable value by Rs. 5,00,000. Is a separate disclosure necessary?

(ii) A Limited company has been including interest in the valuation of closing stock. In 2008-2009, 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 Rs. 3,00,000. Is a disclosure necessary? If so, draft the same.

(iii) A company signed an agreement with the Employees Union on 1.9.2008 for revision of wages with retrospective effect from 30.9.2008. This would cost the company an additional liability of Rs. 5,00,000 per annum. Is a disclosure necessary for the amount paid in 2008-09?

Answer 10.

(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 2008-2009.

"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 Rs. 3,00,000."

(iii) It is given that revision of wages took place on 1st September, 2009 with retrospective effect from 30.9.2008. Therefore wages payable for the half year from 1.10.2008 to 31.3.2009 cannot be taken as an error or omission in the preparation of financial statements and hence this expenditure cannot be taken as a prior period item.

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

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.

Q11. XYZ Ltd. has undertaken a project for expansion of capacity as per the following details:

	Plan Rs.	Actual Rs.
April, 2009	2,00,000	2,00,000
May, 2009	2,00,000	3,00,000
June, 2009	10,00,000	–
July, 2009	1,00,000	–
August, 2009	2,00,000	1,00,000
September, 2009	5,00,000	7,00,000

The company pays to its bankers at the rate of 12% p.a., interest being debited on a monthly basis. During the half year company had Rs. 10 lakhs overdraft upto 31st July, surplus cash in August and again overdraft of over Rs. 10 lakhs from 1.9.2009. The company had a strike during June and hence could not continue the work during June. Work was again commenced on 1st July and all the works were completed on 30th September. Assume that expenditure were incurred on 1st day of each month.

Calculate:

(i) Interest to be capitalised.

(ii) Give reasons wherever necessary.

Assume:

(a) Overdraft will be less, if there is no capital expenditure.

(b) The Board of Directors based on facts and circumstances of the case has decided that any capital expenditure taking more than 3 months as substantial period of time.

Answer 11.

(a) **XYZ Ltd.**

Month	Actual Expenditure Rs.	Interest Capitalised Rs.	Cumulative Amount Rs.	
April, 2009	2,00,000	2,000	2,02,000	
May, 2009	3,00,000	5,020	5,07,020	
June, 2009	–	5,070	5,12,090	Note 2
July, 2009	–	5,120	5,17,210	
August, 2009	1,00,000	–	6,17,210	Note 3
September, 2009	7,00,000	10,000	13,27,210	Note 4
	13,00,000	27,210	13,27,210	

Note:

1. There would not have been overdraft, if there is no capital expenditure. Hence, it is a case of specific borrowing as per AS 16 on Borrowing Costs.
2. The company had a strike in June and hence could not continue the work during June. As per para 14 (c) of AS 16, the activities that are necessary to prepare the asset for its intended use or sale are in progress. The strike is not during extended period. Thus during strike period, interest need to be capitalised.
3. During August, the company did not incur any interest as there was surplus cash in August. Therefore, no amount should be capitalised during August as per para 14(b) of AS 16.
4. During September, it has been taken that actual overdraft is Rs. 10 lakhs only. Hence, only Rs. 10,000 interest has been capitalised even though actual expenditure exceeds Rs. 10 lakhs.

Alternatively, interest may be charged on total amount of (Rs. 6,17,210 + Rs. 7,00,000 = 13,17,210) for the month of September, 2009 as it is given in the question that overdraft was over Rs. 10 lakhs from 1.9.2009 and not exactly Rs. 10 lakhs. In that case, interest amount Rs. 13,172 will be capitalised for the month of September.

Q12. Briefly explain, as per relevant Accounting Standard:

(a) TVSM company has taken a Transit Insurance Policy. Suddenly in the year 2008-2009 the percentage of accident has gone up to 7% and the company wants to recognise insurance claim as revenue in 2008-2009 in accordance with relevant Accounting Standards. Do you agree?

(b) 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 2008-2009 the company wants to recognise the entire interest receivable. Do you agree?

(c) ABC Ltd. was making provision for non-moving stocks based on no issues for the last 12 months upto 31.3.2008.

The company wants to provide during the year ending 31.3.2009 based on technical evaluation :

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

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

(d) XYZ is an export oriented unit and was enjoying tax holiday upto 31.3.2008. No provision for deferred tax liability was made in accounts for the year ended 31.3.2008. While finalising the accounts for the year ended 31.3.2009, the Accountant says that the entire deferred tax liability upto 31.3.2008 and current year deferred tax liability should be routed through Profit and Loss Account as the relevant Accounting Standard has already become mandatory from 1.4.2007. Do you agree?

Answer 12.

(a) AS 9 on Revenue Recognition defines revenue as 'gross inflow of cash, receivables or other consideration arising in the course of the ordinary activities of the 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'.

To recognise revenue AS 9 requires that revenue arises from ordinary activities and that it is measurable and there should be no uncertainty. As per para 9.2 of the Standard, 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, it may be appropriate to recognise revenue only when it is reasonably certain that the ultimate collection will be made.

In the given case, TVSM company wants to suddenly recognise Insurance claim because it has increased over the previous year. But, there are uncertainties involved in the settlement of the claim. Also, the claim does not seem to be in the course of ordinary activity of the company.

Hence, TVSM company is not advised to recognise the Insurance claim as revenue.

(b) 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.

(c) 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 Rs.3.5 lakhs to Rs.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 2008-09:

"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 Rs.1 lakh."

(d) Paragraph 33 of AS 22 on "Accounting For Taxes on Income" relates to the transitional provisions. It says, "On the first occasion that the taxes on income are accounted for in accordance with this statement, the enterprise should recognise, in the financial statements, the deferred tax balance that has accumulated prior to the adoption of this statement as deferred tax asset/liability with a corresponding credit/charge to the revenue reserves, subject to the consideration of prudence in case of deferred tax assets.

Further Paragraph 34 lays down, "For the purpose of determining accumulated deferred tax in the period in which this statement is applied for the first time, the opening balances of assets and liabilities for accounting purposes and for tax purposes are compared and the differences, if any, are determined. The tax effects of these differences, if any, should be recognised as deferred tax assets or liabilities, if these differences are timing differences."

Therefore, in the case of XYZ, even though AS 22 has come into effect from 1.4.2001, the transitional provisions permit adjustment of deferred tax liability/asset upto the previous year to be adjusted from opening reserve. In other words, the deferred taxes not provided for alone can be adjusted against opening reserves.

Provision for deferred tax asset/liability for the current year should be routed through profit and loss account like normal provision.

Q13. PQR Ltd.'s accounting year ends on 31st March. The company made a loss of Rs. 2,00,000 for the year ending 31.3.2007. For the years ending 31.3.2008 and 31.3.2009, it made profits of Rs. 1,00,000 and Rs. 1,20,000 respectively. It is assumed that the loss of a year can be carried forward for eight years and tax rate is 40%. By the end of 31.3.2007, the company feels that there will be sufficient taxable income in the future years against which carry forward loss can be set off. There is no difference between taxable income and accounting income except that the carry forward loss is allowed in the years ending 2008 and 2009 for tax purposes. Prepare a statement of Profit and Loss for the years ending 2007, 2008 and 2009.

Answer 13.

Statement of Profit and Loss

	31.3.2007	31.3.2008	31.3.2009
	Rs.	Rs.	Rs.
Profit (Loss)	(2,00,000)	1,00,000	1,20,000
Less: Current tax			(8,000)
Deferred tax:			
Tax effect of timing differences originating during the year	80,000		
Tax effect of timing differences reversed/ adjusted during the year		(40,000)	(40,000)
Profit (loss) after tax effect	(1,20,000)	60,000	72,000

Q14. (a) At the end of the financial year ending on 31st December, 2008, a company finds that there are twenty law suits outstanding which have not been settled till the date of approval of accounts by the Board of Directors. The possible outcome as estimated by the Board is as follows:

	Probability	Loss (Rs.)
In respect of five cases (Win)	100%	—
Next ten cases (Win)	60%	—
Lose (Low damages)	30%	1,20,000
Lose (High damages)	10%	2,00,000
Remaining five cases		
Win	50%	—
Lose (Low damages)	30%	1,00,000
Lose (High damages)	20%	2,10,000

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

(b) Z Ltd. presents the following information for the year ending 31.03.2008 and 31.03.2009 from which you are required to calculate the Deferred Tax Asset/Liability assuming tax rate of 30% and state how the same should be dealt with as per relevant accounting standard.

	31.03.2008	31.03.2009
	Rs. (lakhs)	Rs. (lakhs)
Depreciation as per books	4,010.10	4,023.54
Unabsorbed carry forward business loss and depreciation allowance	2,016.60	4,110.00
Disallowance under Section 43B of Income tax Act, 1961	518.35	611.45
Deferred Revenue Expenses	4.88	—
Provision for Doubtful Debts	282.51	294.35

Z Ltd. had incurred a loss of Rs. 504 lakhs for the year ending 31.03.2009 before providing for Current Tax of Rs. 26.00 lakhs.

Answer 14.

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

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

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

(iii) The possibility of an outflow of resources embodying economic benefits is also remote.

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

In this case, the probability of winning of first five cases is 100% and hence, question of providing for contingent loss does not arise. The probability of winning of next ten cases is 60% and for remaining five cases is 50%. As per AS 29, we make a provision if the loss is probable. As the loss does not appear to be probable and the possibility of an outflow of resources embodying economic benefits is not remote rather there is reasonable possibility of loss, therefore disclosure by way of note should be made. For the purpose of the disclosure of contingent liability by way of note, amount may be calculated as under:

Expected loss in next ten cases = 30% of Rs. 1,20,000 + 10% of Rs. 2,00,000
= Rs. 36,000 + Rs. 20,000
= Rs. 56,000

Expected loss in remaining five cases = 30% of Rs. 1,00,000 + 20% of Rs. 2,10,000
= Rs. 30,000 + Rs. 42,000
= Rs. 72,000

To disclose contingent liability on the basis of maximum loss will be highly unrealistic. Therefore, the better approach will be to disclose the overall expected loss of Rs. 9,20,000 (Rs. 56,000×10 + Rs. 72,000 × 5) as contingent liability.

(b)

	Rs. in lakhs 31.3.2008	**Rs. in lakhs 31.3.2009**
Carried Forward Business Loss and Depreciation Allowance	2,016.60	4,110.00
Ad: Disallowance under Section 43 B of Income Tax Act,1961	518.35	611.45
Provision for Doubtful Debts	282.51	294.35
	2,817.46	5,015.80
Less: Depreciation	4,010.10	4,023.54
	(-) 1,192.64	992.26
Less: Deferred Revenue Expenditure*	4.88	—
Timing Differences	(-) 1,197.52	992.26
Deferred Tax Liability	359.26	
Deferred Tax Asset		297.68

Where an enterprise has unabsorbed depreciation or carry forward of losses under tax laws, deferred tax assets should be recognized only to the extent that there is virtual certainty supported by convincing evidence that future taxable income will be available against which such deferred tax assets can be realized. The existence of unabsorbed depreciation or carry forward of losses is strong evidence that future taxable income may not be available. Deferred Tax Asset of Rs. 297.68 lakhs should not be recognized as an asset as per para 17 of AS 22 on 'Accounting for Taxes on Income'. Deferred Tax Liability of Rs. 359.26 lakhs should be disclosed under a separate heading in the balance sheet of Z Ltd., separately from current assets and current liabilities.

Q15. Briefly explain as per relevant Guidance Notes:

(a) HSL Ltd. is manufacturing goods for local sale and exports. As on 31st March, 2009, it has the following finished stocks in the factory warehouse:

(i) Goods meant for local sale Rs. 100 lakhs (cost Rs. 75 lakhs).

(ii) Goods meant for exports Rs. 50 lakhs (cost Rs. 20 lakhs).

Excise duty is payable at the rate of 16%. The company's Managing Director says that excise duty is payable only on clearance of goods and hence is not a cost. Please advise HSL using guidance note, if any issued on this, including valuation of stock.

(b) SFL Ltd. is a mutual fund. The fund values the investment on "mark to market basis". The Accountant argues since investment are valued on the above basis there is no necessity to disclose depreciation separately in the financial statements. Do you agree?

(c) A company has given counter guarantees of Rs. 2.25 crores to various banks in respect of the guarantees given by the said banks in favour of Government authorities. Outstanding counter guarantees as at the end of financial year 2008-2009 were Rs. 1.95 crores. How should this information be shown in the Financial Statements of the Company.

Answer 15.

(a) Guidance Note on Accounting Treatment for Excise Duty says that excise duty is a duty on manufacture or production of excisable goods in India.

According to Central Excise Rules, 2002, excise duty should be collected at the time of removal of goods from factory premises or factory warehouse. The levy of excise duty is upon the manufacture or production, the collection part of it is shifted to the stage of removal.

Further, paragraph 23(i) of the Guidance Note makes it clear that excise duty should be considered as a manufacturing expense and like other manufacturing expenses be considered as an element of cost for inventory valuation.

Therefore, in the given case of HSL Ltd., the Managing Director's contention that "excise duty is payable only on clearance of goods and hence is not a cost is incorrect. Excise duty on the goods meant for local sales should be provided for at the rate of 16% on the selling price, that is, Rs. 100 lakhs for valuation of stock.

Excise duty on goods meant for exports, should be provided for, since the liability for excise duty arises when the manufacture of the goods is completed. However, if it is assumed that all the conditions specified in Rule 19 of the Central Excise Rules, 2002 regarding export of excisable goods without payment of duty are fulfilled by HSL Ltd., excise duty may not be provided for.

(b) The Guidance Note on Accounting for Investments in the Financial statements of Mutual Funds provides that the investments should be marked to market on the balance sheet date. The provision for depreciation in the value of investments should be made in the books by debiting the Revenue Account. The provision so created should be shown as a deduction from the value of investments in the balance sheet. Clause 2(i) of the Eleventh Schedule provides that "where the financial statements are prepared on a mark to market basis, there need not be a separate provision for depreciation."

However keeping in view, 'prudence' as a factor for preparation of financial statements and correct disclosure of the amount of depreciation on investments, the guidance note recommends that the gross value of depreciation on investments should be reflected in the Revenue Account rather than the same being netted off with the appreciation in the value of other investments. In other words, depreciation/appreciation on investments should be worked out on an individual investment basis or by category of investment basis, but not on an overall basis or by category of investment.

In the given case of SFL Ltd., depreciation should be separately disclosed in the financial statements.

(c) The counter guarantee given by the company is, infact, an undertaking to perform what is, in any event, the obligation of the company itself. In any case, this is a matter which is in the control of the company itself and the mere possibility of a default by the company in the future cannot be said to involve the existence of a contingent liability on the balance sheet date.

Thus, as per 'Guidance Note on Guarantees and Counter-Guarantees given by Companies', no separate disclosure is required in respect of counter guarantees.

Q16. E Ltd. manufactures and sells food products. The following draft financial statements were prepared by the chief accountant for the year ended 31.3.2009 and placed before your for advice:

Profit and Loss Statement for the year ended 31.3.2009

(Figures in Rs. lakhs)

Sales and other income	3,500
Cost of goods sold including operating expenses and depreciation	2,740
Operating profit	760
Profit on sale of property	200
Interest charges	300
Profit before tax	660
Tax provision	330
Profit after tax	330
Proposed dividend	300
Profit retained	30
Add: Opening balance of profit	360
Profit carried to Balance Sheet	390

Balance Sheet as on 31.3.2009 (Figures in Rs. lakhs)

Liabilities			Assets		
Share Capital		3,000	Fixed Assets	5,000	
General reserve		540	Less: Depreciation	1,000	4,000
Profit and loss account balance		390	Current Assets		
Secured Loans		2,000	Stock	800	
Current Liabilities and Provisions			Debtors	1,000	
Creditors	240		Royalty receivable	100	
Provision for tax	330		Advance tax	200	
Proposed dividend	300	870	Cash balance	550	2,650
		—	Miscellaneous expenditure to the extent not written off	150	
		6,800		6,800	

You are provided with further information as follows:

(a) On 1.4.08 E Ltd. had sold some of its fixed assets for Rs.100 lakhs [written down value Rs. 250 lakhs]. These assets were revalued earlier. As on 1.4.08 the revaluation reserve corresponding to these assets stood at Rs. 200 lakhs. The profit on sale of property as shown in the profit and loss statement represented the transfer of this amount. Loss on sale of the asset was included in the cost of goods sold etc.

(b) During the year E Ltd. undertook restructuring exercise of its operations at a cost of Rs. 150 lakhs. This amount stood included in "miscellaneous expenditure to the extent not written off".

(c) Included in sales and other income is a sum of Rs. 100 lakhs representing royalty receivable for supply of know-how to a company in South-East Asia. As per agreement the amount is to be received in US Dollars. However, exchange permission was denied to the company in South-East Asia for remitting the same.

(d) E Ltd. purchased fixed assets costing Rs. 1,825 lakhs on 1.4.08 and the same was fully financed by foreign currency loan [i.e. US Dollars] repayable in five equal instalments annually. [Exchange rate at the time of purchase was 1 US Dollar = Rs. 36.50]. As on 31.3.09 the first instalment was paid when 1 US Dollar fetched Rs. 41.50. The entire loss on exchange was included in cost of goods sold etc. E Ltd. normally provides depreciation on fixed assets at 20% on WDV basis.

(e) Dividend at 10% on paid up equity capital is to be maintained as in prior years.

You are required to redraft the financial statements of E Ltd. for the year ended 31.3.09 in accordance with relevant provisions of accounting standards. Journal entries (wherever applicable) in respect of the information given are to be shown. Schedules previous year's figures and cash flow statement are not required.

Answer 16.

(a) As per para 14.4 and para 32 of AS 10 on Accounting for Fixed Assets, on disposal or 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. Accordingly, the following journal entries are to be passed.

		(Rs. in lakhs)
Profit on Sale of Property	Dr.	200
To Loss on Sale of Fixed Assets		150
To General Reserve		50

[Alternatively, these entries can be passed through Revaluation Reserve Account. That is, 'Profit on Sale of Property' can be credited first to Revaluation Reserve Account and then, this Reserve will be debited with loss on sale of fixed assets (included in 'Cost of Goods Sold etc.') and the balance will be transferred to General Reserve.]

(b) As per para 12 of AS 5 (Revised) on Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies, 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 entire restructuring cost Rs. 150 lakhs requires separate disclosure in the statement of profit and loss instead of deferring and showing it under miscellaneous expenditure.

(c) According to 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.

Thus 'Sales and other income' should be reduced by Rs. 100 lakhs with equivalent credit to Royalty Receivable Account.

Alternatively, the students may apply para 9.3 of AS 9, after making reasonable assumption as to the timing of the uncertainty. According to para 9.3, 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.

(d) 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 incomes/expenses in the period in which they arise.

Calculation of Exchange loss :

$$\text{Foreign currency loan} = \frac{\text{Rs.1,825 lakhs}}{\text{Rs. 36.50}} = \text{50 lakhs US Dollars}$$

Exchange loss = 50 lakhs US dollars × (41.50 – 36.50) = Rs. 250 lakhs (including exchange loss on payment of first instalment)

Thus exchange loss of Rs. 250 lakhs should be recognized as expense in the profit and loss account for the year ended 31st March, 2009.

E Ltd.

Balance Sheet as at 31st March, 2009

			(Rs.in lakhs)
I SOURCES OF FUNDS			
(1) Shareholders' funds:			
(a) Capital		3,000	
(b) Reserves and surplus			
General Reserve	590		
Profit and Loss Account	240	830	3,830
(2) Loan funds:			
(a) Secured loans		2,000	
(b) Unsecured loans		—	2,000
TOTAL			5,830
II APPLICATION OF FUNDS			
(1) Fixed assets:			
(a) Gross block		5,000	
(b) Less: Depreciation		1,000	
(c) Net block		4,000	
(d) Capital work in progress		—	4,000
(2) Investments			—
(3) Current assets, loans and advances:			
(a) Inventories		800	
(b) Sundry debtors		1,000	
(c) Cash balance		550	
(d) Other current assets		—	
(e) Loans and advances (Advance tax)		200	
		2,550	
Less: Current Liabilities and Provisions :			
(a) Liabilities		240	
(b) Provisions			
Provision for Taxation	180		
Proposed Dividend	300	480	
		720	
Net current assets			1,830
(4) Miscellaneous expenditure			—
(to the extent not written off or adjusted)			
TOTAL			5,830

Profit and Loss Account

for the year ended 31st March, 2009 (Rs. in lakhs)

Sales and other income (3,500 – 100)	3,400
Cost of goods sold including operating expenses and depreciation (2,740 – 150 – 250)	(2,340)
Restructuring cost	(150)
Interest charges	(300)
Foreign exchange loss	(250)
Profit before taxation	360
Provision for tax (@ 50%)	(180)
Net Profit	180
Balance brought forward from previous year	360
Profit Available for Appropriation	540
Proposed Dividend	(300)
Balance Carried Forward	240

Current year profit after tax is only Rs. 180 lakhs as against the proposed dividend of Rs. 300 lakhs. Hence, in order to ensure sufficient compliance with section 205 of the Companies Act, 1956, past profits are utilized to make up the shotfall (assuming that there are no arrears of depreciation).

Note on Accounts: The royalty receivable in US Dollars for supply of know-how to a company in South-East Asia amounting to Rs. 100 lakhs has not been recognized as exchange permission has been denied to the company in South-East Asia for remitting the same.

Notes :

1. In the absence of any information regarding interest on foreign currency loan taken for financing purchase of fixed assets, no provision has been made for interest liability.
2. Deferred tax for the timing difference arising due to treatment of exchange loss on repayment of principal portion of the foreign currency loan is to be accounted for in accordance with AS 22 'Accounting for Taxes on Income'. In the above solution, the exchange loss on repayment of principal amount has been charged to profit and loss account. However, as per Section 43 A of the Income Tax Act, such exchange loss is required to be capitalized and depreciation is to be provided for. In the absence of information regarding nature of fixed asset, the rate of depreciation under Income Tax Act cannot be determined. Hence, the effect of AS 22 has not been disclosed in the redrafted financial statements.
3. Schedule VI to the Companies Act, 1956, provides that the exchange differences arising on repayment of liabilities incurred for the purpose of acquiring fixed assets should be adjusted in the carrying amount of respective fixed assets. The revised AS 11 (2003), however, does not require the adjustment of exchange differences in the carrying amount of fixed assets, and such exchange differences are required to be recognized in the statement of profit and loss since it is felt that this treatment is conceptually preferable to that required in Schedule VI.

   The above answer has been given according to revised AS 11 (2003).
4. It has been assumed that restructuring costs are of revenue nature and thus are allowed for tax purposes.

Q17. A Ltd. and B Ltd. were amalgamated on and from 1st April, 2009. A new company C Ltd. was formed to take over the business of the existing companies. The Balance Sheets of A Ltd. and B Ltd. as on 31st March, 2009 are given below :

(Rs. in lakhs)

Liabilities	A Ltd.	B Ltd.	Assets	A Ltd.	B Ltd.
Share Capital			Fixed Assets		
Equity Shares of Rs. 100 each	800	750	Land and Building	550	400
12% Preference shares of Rs.100 each	300	200	Plant and Machinery	350	250
Reserves and Surplus			Investments	150	50
Revaluation Reserve	100	150	Current Assets,		
General Reserve	150	170	Loans and Advances		
Investment Allowance Reserve	50	50	Stock	350	250
Profit and Loss Account	50	30	Sundry Debtors	250	300
Secured Loans			Bills Receivable	50	50
10% Debentures (Rs. 100 each)	60	30	Cash and Bank	300	200
Current Liabilities and provisions					
Sundry Creditors	270	120			
Bills Payable	150	70		—	—
	2,000	1,500		2,000	1,500

Additional Information :

(1) 10% Debentureholders of A Ltd. and B Ltd. are discharged by C Ltd. issuing such number of its 15% Debentures of Rs. 100 each so as to maintain the same amount of interest.

(2) Preference shareholders of the two companies are issued equivalent number of 15% preference shares of C Ltd. at a price of Rs. 150 per share (face value of Rs. 100).

(3) C Ltd. will issue 5 equity shares for each equity share of A Ltd. and 4 equity shares for each equity share of B Ltd. The shares are to be issued @ Rs. 30 each, having a face value of Rs. 10 per share.

(4) Investment allowance reserve is to be maintained for 4 more years.

Prepare the Balance Sheet of C Ltd. as on 1st April, 2009 after the amalgamation has been carried out on the basis of Amalgamation in the nature of purchase.

Answer 17.

Balance Sheet of C Ltd. as at 1st April, 2009

(Rs.In lakhs)

Liabilities		Amount	Assets	Amount
SHARE CAPITAL			FIXED ASSETS	
70,00,000 Equity shares of Rs.10 each		700	Goodwill	20
			Land and Building	950
5,00,000 Preference shares of Rs. 100 each (all the above shares are allotted as fully paid-up pursuant to contracts without payment being received in cash)		500	Plant and Machinery	600
			INVESTMENTS	200
			CURRENT ASSETS, LOANS AND ADVANCES	
RESERVES AND SURPLUS			A. Current Assets	
Securities Premium Account		1,650	Stock	600
Investment Allowance Reserve		100	Sundry debtors	550
SECURED LOANS			Cash and Bank	500
15% Debentures		60	B. Loans and Advances	
UNSECURED LOANS		—	Bills Receivable	100
CURRENT LIABILITIES AND PROVISIONS			MISCELLANEOUS EXPENDITURE (to the extent not written off or adjusted)	
A Current Liabilities Acceptances	220		Amalgamation Adjustment Account	100
Sundry Creditors	390			
B Provisions	—	610		
		3,620		3,620

Working Notes :

(Rs. in lakhs)

	A Ltd.	B Ltd.
(1) Computation of Purchase consideration		
(a) Preference shareholders:		
$\left(\frac{3,00,00,000}{100} \text{ i.e. } 3,00,000 \text{ shares}\right) \times \text{Rs. } 150 \text{ each}$	450	
$\left(\frac{2,00,00,000}{100} \text{ i.e. } 2,00,000 \text{ shares}\right) \times \text{Rs. } 150 \text{ each}$		300
(b) Equity shareholders:		
$\left(\frac{8,00,00,000 \times 5}{100} \text{ i.e. } 40,00,000 \text{ shares}\right) \times \text{Rs. } 30 \text{ each}$	1200	

$\left(\frac{7,50,00,000 \times 4}{100} \text{ i.e. } 30,00,000 \text{ shares}\right) \times$ Rs. 30 each	900			
Amount of Purchase Consideration	1,650	1,200		
(2) Net Assets Taken Over				
Assets taken over:				
Land and Building	550	400		
Plant and Machinery	350	250		
Investments	150	50		
Stock	350	250		
Sundry Debtors	250	300		
Bills receivable	50	50		
Cash and bank	300	200		
	2,000	1,500		
Less: Liabilities taken over:				
Debentures	40		20	
Sundry Creditors	270		120	
Bills payable	150		70	
		460		210
Net assets taken over		1,540		1,290
Purchase consideration		1,650		1,200
Goodwill		110		—
Capital reserve			90	

Note:

Since Investment Allowance Reserve is to be maintained for 4 more years, it is carried forward by a corresponding debit to Amalgamation Adjustment Account in accordance with AS-14.

Q18. The following are the Balance Sheets of Big Ltd. and Small Ltd. for the year ending on 31st March, 2009. (Figures in crores of rupees):

	Big Ltd.	**Small Ltd.**
Equity share capital – in equity shares of Rs. 10 each	**50**	**40**
Preference share capital – in 10% preference shares of Rs. 100 each	**—**	**60**
Reserves and Surplus	**200**	**150**
	250	**250**
Loans – Secured	**100**	**100**
Total funds	**350**	**350**
Applied for: Fixed assets at cost less depreciation	**150**	**150**
Current assets less current liabilities	**200**	**200**
	350	**350**

The present worth of fixed assets of Big Ltd. is Rs. 200 crores and that of Small Ltd. is Rs. 429 crores. Goodwill of Big Ltd. is Rs. 40 crores and of Small Ltd. is 75 crores.

Small Ltd. absorbs Big Ltd. by issuing equity shares at par in such a way that intrinsic net worth is maintained.

Goodwill account is not to appear in the books. Fixed assets are to appear at old figures.

(a) Show the Balance Sheet after absorption.

(b) Draft a statement of valuation of shares on intrinsic value basis and prove the accuracy of your workings.

Answer18. **Small Ltd.**

Balance Sheet as at 1st April, 2009

	Schedule No.	(Rs.in crores)	
I SOURCES OF FUNDS			
(1) Shareholders' funds:			
(a) Capital	A	125	
(b) Reserves and surplus	B	375	
			500
(2) Loan funds:			
Secured loans	C		200
TOTAL			700
II APPLICATION OF FUNDS			
(1) Fixed assets:			
Net block	D		300
(2) Investments			–
(3) Net current assets	E		400
TOTAL			700
(Rs. in Crores)			

Schedules to Accounts:

A. Share Capital:

6.5 crores equity shares of Rs. 10 each (of the above shares, 2.5 crores equity shares are allotted as fully paid-up for consideration other than cash)	65	
60 lakhs 10% Preference shares of Rs. 100 each	60	
		125

B. Reserves and Surplus:

As per last Balance Sheet	150
Capital Reserve	225
	375

C.	Secured Loans:	
	As per last Balance Sheet	100
	Taken over on absorption of Big Ltd.	100
		200
D	Fixed Assets:	
	As per last Balance Sheet	150
	Taken over on absorption of Big Ltd.	150
		300
E	Net Current Assets:	
	As per last Balance Sheet	200
	Taken over on absorption of Big Ltd.	200
		400

(b) **Valuation of shares on intrinsic value basis**

(i)	**Big Ltd.**	**Small Ltd.**
	(Rs. in crores)	
Equity share capital	50	40
Reserves and Surplus	200	150
250 190		
Goodwill agreed upon	40	75
Increase in the value of fixed assets		
(Present worth less book value)	50	279
	340	544

(ii)	**Big Ltd.**	**Small Ltd.**
Number of Equity shares	5 crores	4 crores
Intrinsic value per equity share	Rs. 68	Rs. 136
(iii) Ratio of intrinsic value of shares in the two companies	1 : 2	

Since the shares are to be issued at par, the number of equity shares of Rs. 10 each to be issued to maintain the intrinsic net worth = 5 crores /2 = 2.5 crores

(iv) Statement to prove the accuracy of workings

		(Rs. in crores)
(1)	Equity share capital (after absorption)	65
	Reserves and Surplus (after absorption)	375
		440
	Add: Unrecorded value of goodwill (40+75)	115
	Add: Unrecorded incremental value of fixed assets (50+279)	329
		884

(2)	Number of equity shares	6.5 crores
(3)	Intrinsic value of an equity share (884/6.5)	Rs. 136

Working Note :

Calculation of Capital Reserve on Absorption	(Rs. in crores)
Fixed Assets taken over	150
Net current assets taken over	200
	350
Less: Secured loans taken over	100
Net Assets taken over	250
Less: Purchase consideration	25
	225

Q19. AB Ltd. and MB Ltd. decide to amalgamate and to form a new company AM Ltd. The following are their balance sheets as at 31.3.2009:

Liabilities	AB Ltd.	MB Ltd.	Assets	AB Ltd.	MB Ltd.
Share Capital	10,00,000	6,00,000	Fixed Assets	7,50,000	2,00,000
(Rs. 100) each			Investments:		
General Reserve	1,00,000	50,000	1,500 Shares in MB	3,50,000	—
Investment Allowance Reserve	40,000	30,000	4,000 Shares in AB	—	5,00,000
12% Debentures			Current Assets	4,00,000	1,00,000
(Rs. 100 each)	3,00,000	1,00,000			
Sundry Creditors	60,000	20,000		—	—
	15,00,000	8,00,000		15,00,000	8,00,000

Calculate the amount of purchase consideration for AB Ltd. and MB Ltd. and draw up the balance sheet of AM Ltd. after considering the following:

(a) Assume amalgamation is in the nature of purchase.

(b) Fixed assets of AB Ltd. are to be reduced by Rs. 50,000 and that of MB Ltd. are to be taken at Rs. 3,00,000.

(c) 2% debentureholders of AB Ltd. and MB Ltd. are discharged by AM Ltd. by issuing such number of its 15% debentures of Rs. 100 each so as to maintain the same amount of interest.

(d) Shares of AM Ltd. are of Rs. 100 each.

Also show, how the investment allowance reserve will be treated in the Financial Statement assuming the Reserve will be maintained for 3 years.

Answer 19.

(i) **Calculation of Purchase consideration**

Value of Net Assets of AB Ltd. and MB Ltd. as on 31st March, 2009

	AB Ltd. **Rs.**		**MB Ltd.** **Rs.**	
Assets taken over:				
Fixed Assets	7,00,000		3,00,000	
Current Assets	4,00,000	11,00,000	1,00,000	4,00,000
Less: Liabilities taken over:				
Debentures	2,40,000*		80,000**	
Sundry Creditors	60,000	3,00,000	20,000	1,00,000
	8,00,000		**3,00,000**	

$$*\ 3{,}00{,}000 \times \frac{12}{100} \times \frac{100}{15} = \text{Rs. } 2{,}40{,}000$$

$$**\ 1{,}00{,}000 \times \frac{12}{100} \times \frac{100}{15} = \text{Rs. } 80{,}000$$

(ii) Value of Shares of AB Ltd. and MB Ltd.

The value of shares of AB Ltd. is Rs. 8,00,000 plus 1/4 of the value of the shares of MB Ltd.

Similarly, the value of shares of MB Ltd. is Rs. 3,00,000 plus 2/5 of the value of shares of AB Ltd.

Let a denote the value of shares of AB Ltd. and m denote the value of shares of MB Ltd. then

$$a = 8{,}00{,}000 + \frac{1}{4}\ m \text{ ; and}$$

$$M = 3{,}00{,}000 + \frac{2}{5}\ a.$$

Substituting the value of m,

$$a = 8{,}00{,}000 + \frac{1}{4}\left(3{,}00{,}000 \frac{2}{5} a\right)$$

$$a = 8{,}00{,}000 + 75{,}000 + \frac{1}{10} a$$

$$\frac{9}{10a} = 8{,}75{,}000$$

$$a = 9{,}72{,}222$$

$$m = 3{,}00{,}000 + \frac{2}{5}(9{,}72{,}222)$$

$$m = 6{,}88{,}889$$

(iii) Amount of Purchase Consideration

	AB Ltd.	MB Ltd.
	Rs.	Rs.
Total value of shares (as determined above)	9,72,222	6,88,889
Less: Internal investments:		
$\frac{2}{5}$ for shares held by MB Ltd.	3,88,889	
$\frac{1}{4}$ for shares held by AB Ltd.	—	1,72,222
Amount due to outsiders	5,83,333	5,16,667

Purchase Consideration will be satisfied by AM Ltd. as follows:

	AB Ltd.	MB Ltd.
	Rs.	Rs.
In shares (of Rs. 100 each)	5,83,300	5,16,600
In cash	33	67

(iv) Net Amount of Goodwill/Capital Reserve	**Rs.**	**Rs.**
Total Purchase Consideration		
AB Ltd.	5,83,333	
MB Ltd.	5,16,667	11,00,000
Less: Net Assets taken over		
AB Ltd.	8,00,000	
MB Ltd.	3,00,000	11,00,000
		Nil

(Alternatively, the calculations may be made separately for both the companies)

Balance Sheet of AM Ltd.as at 31st March, 2009

Liabilities	Amount Rs.	Assets	Amount Rs.
Share Capital 10,999 shares of Rs. 100 each	10,99,900	Goodwill	—
(All the above shares are allotted as fully paid-up for consideration other than cash)		Fixed Assets Investments	10,00,000 —
Investment Allowance Reserve	70,000	Current Assets	4,99,900
15% Debentures	3,20,000	(5,00,000 – 33 – 67)	
Sundry Creditors	80,000	Miscellaneous Expenditure	
		(to the extent not written off or adjusted): Amalgamation Adjustment Account	70,000
	15,69,900		15,69,900

Q20. The Balance Sheets of Big Ltd. and Small Ltd. as at 31.3.09 (Rs. In lakhs)

	Big Ltd. Rs.	Small Ltd. Rs.		Big Ltd. Rs.	Small Ltd. Rs.
Share Capital	40	15	Sundry Assets (including cost of shares)	56	20
Profit & Loss A/c	7.5	—	Goodwill	4	5
Sundry Creditors	12.5	12.5	Profit and Loss A/c	—	2.5
	60.0	27.5		60.0	27.5

Additional Information :

(i) The two companies agree to amalgamate and form a new company, Medium Ltd.

(ii) Big Ltd. holds 10,000 shares in Small Ltd. acquired at a cost of Rs.2,50,000 and Small Ltd. holds 5,000 shares in Big Ltd. acquired at a cost of Rs.7,00,000.

(iii) The shares of Big Ltd. are of Rs.100 and are fully paid and the shares of Small Ltd. are of Rs.50 each on which Rs.30 has been paid-up.

(iv) It is agreed that the goodwill of Big Ltd. would be valued at Rs.1,50,000 and that of Small Ltd. at Rs.2,50,000.

(v) The shares which each company holds in the other are to be valued at book value having regard to the goodwill valuation decided as given in (iv).

(vi) The new shares are to be of a nominal value of Rs.50 each credited as Rs.25 paid.

You are required to:

(i) Prepare the Balance Sheet of Medium Ltd., as at 31st March, 2009 after giving effect to the above transactions; and

(ii) Prepare a statement showing the shareholdings in the new company attributable to the shareholders of the merged companies.

Answer 20.

(i) **Balance Sheet of Medium Ltd. as on 31st March, 2009**

Liabilities	Rs.	Assets	Rs.
1,82,000 shares of Rs. 50/- each, Rs. 25 paid up [Issued for consideration other than cash]	45,50,000	Goodwill (Rs. 1,50,000+Rs. 2,50,000)	4,00,000
		Sundry Assets	4,00,000
Sundry Creditors	25,00,000	(Rs. 53,50,000+ Rs. 13,00,000)	66,50,000
	70,50,000		70,50,000

(ii) **Statement of Shareholding in Medium Ltd.**

	Big Ltd. Rs.	Small Ltd. Rs.
Total value of Assets	44,20,513	8,52,564
Less: Pertaining to shares held by the other company	5,52,564	1,70,513
	38,67,949	6,82,051
Rounded off to	38,67,950	6,82,050
Shares of new company (at Rs. 25 per share)	1,54,718	27,282

Total purchase consideration to be paid to Big Ltd and Small Ltd.

(Rs.38,67,950 + Rs.6,82,050)= Rs.45,50,000

Number of shares in Big Ltd. (40,00,000/100)	40,000 shares
Number of shares in Small Ltd. (15,00,000/30)	50,000 shares
Holding of Small Ltd. in Big Ltd. (5,000/40,000)	1/8
Holding of Big Ltd. in Small Ltd. (10,000/50,000)	1/5
Number of shares held by outsiders in Big Ltd. (40,000 – 5,000) =	35,000
Number of shares held by outsiders in Small Ltd. (50,000 – 10,000) =	40,000

Workings Note:

Calculation of Book Value of Shares

	Big Ltd **Rs.**	**Small Ltd.** **Rs.**
Goodwill	1,50,000	2,50,000
Sundry Assets other than shares in other company		
(56,00,000 – 2,50,000)(20,00,000 – 7,00,000)	53,50,000	13,00,000
	55,00,000	15,50,000
Less: Sundry Creditors	12,50,000	12,50,000
	42,50,000	3,00,000

If "x" is the Book Value of Assets of Big Ltd and "y" of Small Ltd.

$$x = 42{,}50{,}000 + \frac{1}{5}y$$

$$y = 3{,}00{,}000 + \frac{1}{8}x$$

$$x = 42{,}50{,}000 + \frac{1}{5}\left(3{,}00{,}000 + \frac{1}{8}x\right)$$

$$= 42{,}50{,}000 + 60{,}000 + \frac{1}{40}x$$

$$\frac{39}{40}x = 43{,}10{,}000$$

$$x = 43{,}10{,}000 \times \frac{40}{39}$$

$$x = 44{,}20{,}513 \text{ (approx.)}$$

$$y = 3{,}00{,}000 + \frac{1}{8}(44{,}20{,}513)$$

$$= 3{,}00{,}000 + 5{,}52{,}564$$

$$= \text{Rs. } 8{,}52{,}564 \text{ (approx.)}$$

Book Value of one share of Big Ltd. $= \frac{44,20,513}{40,000} = \text{Rs. } 110.513 \text{ (approx)}$

Book Value of one share of Small Ltd. $= \frac{8,25,564}{50,000} = \text{Rs. } 17.05 \text{ (approx)}.$

Q21. The Balance Sheets of R Ltd. for the years ended on 31.3.2007, 31.3.2008 and 31.3.2009 are as follows:

Liabilities	31.3.2007 Rs.	31.3.2008 Rs.	31.3.2009 Rs.
3,20,000 Equity Shares of Rs. 10 each fully paid	32,00,000	32,00,000	32,00,000
General Reserve	24,00,000	28,00,000	32,00,000
Profit and Loss Account	2,80,000	3,20,000	4,80,000
Creditors	12,00,000	16,00,000	20,00,000
	70,80,000	79,20,000	88,80,000
Assets	**31.3.2007 Rs.**	**31.3.2008 Rs.**	**31.3.2009 Rs.**
Goodwill	20,00,000	16,00,000	12,00,000
Building and Machinery(Less: Depreciation)	28,00,000	32,00,000	32,00,000
Stock	20,00,000	24,00,000	28,00,000
Debtors	40,000	3,20,000	8,80,000
Bank Balance	2,40,000	4,00,000	8,00,000
	70,80,000	79,20,000	88,80,000

Actual valuation were as under:

	31.3.2007 Rs.	31.3.2008 Rs.	31.3.2009 Rs.
Building and Machinery	36,00,000	40,00,000	44,00,000
Stock	24,00,000	28,00,000	32,00,000
Net Profit (including opening balance) after writing off depreciation and goodwill, tax provision and transfer to General Reserve	8,40,000	12,40,000	16,40,000

Capital employed in the business at market values at the beginning of 2006-07 was Rs. 73,20,000, which included the cost of goodwill. The normal annual return on Average Capital employed in the line of business engaged by R Ltd. is 12½%.

The balance in the General Reserve account on 1st April, 2006 was Rs. 20 lakhs.

The goodwill shown on 31.3.2009 was purchased on 1.4.2006 for Rs. 20,00,000 on which date the balance in the Profit and Loss Account was Rs. 2,40,000. Find out the average capital employed each year.

Goodwill is to be valued at 5 years purchase of super profits (Simple average method). Also find out the total value of the business as on 31.3.2009.

Answer 21.

Note:

1. Since goodwill has been paid for, it is taken as part of capital employed. Capital employed at the end of each year is shown below.
2. Assumed that the building and machinery figure as revalued is after considering depreciation.

	31.3.2007 Rs.	31.3.2008 Rs.	31.3.2009 Rs.
Goodwill	20,00,000	16,00,000	12,00,000
Building and Machinery (revalued)	36,00,000	40,00,000	44,00,000
Stock (revalued)	24,00,000	28,00,000	32,00,000
Debtors	40,000	3,20,000	8,80,000
Bank Balance	2,40,000	4,00,000	8,00,000
Total Assets	82,80,000	91,20,000	1,04,80,000
Less: Creditors	12,00,000	16,00,000	20,00,000
Closing Capital	70,80,000	75,20,000	84,80,000
Opening Capital	73,20,000	70,80,000	75,20,000
	1,44,00,000	1,46,00,000	1,60,00,000
Average Capital	72,00,000	73,00,000	80,00,000

Maintainable profit has to be found out after making adjustments as given below :

	31.3.2007 Rs.	31.3.2008 Rs.	31.3.2009 Rs.
Net Profit as given	8,40,000	12,40,000	16,40,000
Less: Opening Balance	2,40,000	2,80,000	3,20,000
6,00,000	9,60,000	13,20,000	
Add: Under valuation of closing stock	4,00,000	4,00,000	4,00,000
10,00,000	13,60,000	17,20,000	
Less: Adjustment for valuation in opening stock	—	4,00,000	4,00,000
10,00,000	9,60,000	13,20,000	
Add: Goodwill written-off	—	4,00,000	4,00,000
10,00,000	13,60,000	17,20,000	
Add: Transfer to Reserves	4,00,000	4,00,000	4,00,000
14,00,000	17,60,000	21,20,000	
Less: 12½% Normal Return	9,00,000	9,12,500	10,00,000
Super Profit	5,00,000	8,47,500	11,20,000

Average super profits = (Rs.5,00,000 + Rs.8,47,500 + Rs.11,20,000) / 3

= 24,67,500 / 3 = Rs 8,22,500

Goodwill = 5 years purchase = Rs. 8,22,500 × 5 = Rs. 41,12,500.

	Rs.
Total Net Assets (31/3/2009)	84,80,000
Less: Goodwill	12,00,000
	72,80,000
Add: Goodwill	41,12,500
Value of Business	1,13,92,500

Q22. P Limited is considering the acquisition of R Limited. The financial data at the time of acquisition being:

	P Ltd.	R Ltd.
Net profit after tax (Rs. in lakhs)	60	12
Number of shares (lakhs)	12	5
Earning per share (Rs.)	5	2.40
Market price per share (Rs.)	150	48
Price earning ratio	30	20

It is expected that the net profit after tax of the two companies would continue to be Rs.72 lakhs even after the amalgamation.

Explain the effect on EPS of the merged company under each of the following situations:

(i) P Ltd. offers to pay Rs.60 per share to the shareholders of R Ltd.

(ii) P Ltd. offers to pay Rs.78 per share to the shareholders of R Ltd.

The amount in both cases is to be paid in the form of shares of P Ltd.

Answer 22.

(i) In this case, P Ltd. offers to pay Rs.60 per share.

The share exchange ratio would be $\frac{60}{150} = 0.4$

It means, P Ltd. would give 0.4 shares for every one share of R Ltd. In other words, P Ltd. would give 2 shares for 5 shares of R Ltd.

The total number of shares to be issued by P Ltd. to R Ltd.

= 5,00,000 × 0.4 = 2,00,000 shares

or

$5,00,000 \times \frac{2}{5}$ = 2,00,000 shares

Total number of shares of P Ltd. after acquisition of R Ltd.

= 12,00,000 + 2,00,000 = 14,00,000 shares

Calculation of E.P.S. of the amalgamated company

$$= \frac{\text{Total Net Profit after Interest and Tax}}{\text{Total Number of shares}} = \frac{72,00,000}{14,00,000} = \text{Rs. } 5.14 \text{ per share}$$

After amalgamation, The EPS of P Ltd., will improve from Rs.5 to Rs.5.14 whereas EPS of former shareholders of R Ltd would reduce from present 2.40 per share to 5.14 × 0.4 = Rs.2.056 per share after merger.

(ii) In this case, P Ltd. offers Rs.78 per share to the shareholders of R Ltd.

The Exchange Ratio would be $\frac{78}{150} = 0.52$ shares of P Ltd. for each share of R Ltd. In other words, P Ltd would give 52 shares for per 100 shares of R Ltd.

P Ltd would issue 5,00,000 × 0.52 = 2,60,000 shares to shareholders of R Ltd.

E.P.S. of the Merged Company $= \frac{72,00,000}{12,00,000 + 2,60,000} = 4.93$

After Merger, there is a dilution in the E.P.S., of P Ltd. from 5 to 4.93.

After Merger E.P.S. of former shareholders of R Ltd.= 4.93 ´ 0.52 = 2.56

There is a gain of Re. 0.16 in E.P.S. of merged company in comparison to E.P.S. of R Ltd. of Rs.2.40 before merger.

Comments :

Initial increase in and decrease in earnings per share are possible in both cases of Merger. Generally, the dilution in E.P.S. will occur wherever the Price Earnings ratio of acquired company calculated on the basis of price paid exceed the P/E ratio of acquired company and vice-versa.

In Situation (i) - The price offered by P Ltd. per share of R Ltd. is Rs.60 and E.P.S. of R Ltd. is 2.4, which would become the earnings of P Ltd. after merger.

Price Earning (P/E) Ratio of P Ltd. after merger $= \frac{60}{2.40} = 25$. It is lower than the P/E Ratio of P Ltd. before merger i.e., 30, the E.P.S. of P Ltd. after merger increases to Rs.5.14.

In Situation (ii) -The price earnings (P/E) ratio offered for Merger is $\frac{78}{2.4} = 32.5$ which is higher than P/E Ratio of P Ltd. before Merger. Hence, the E.P.S. of P Ltd after merger would get diluted.

Q23.

	Bat Ltd. Rs.	Ball Ltd. Rs.		Bat Ltd. Rs.	Ball Ltd. Rs.
Share Capital (Shares of Rs. 10 each)	1,60,000	2,00,000	Investments Shares in Ball Ltd.	1,96,000	—
Profit and Loss account	50,000	60,000	Debtors	—	1,20,000
Creditors	—	16,000	Stock	—	80,000
			Cash at Bank	—	70,000
	—	—	Cash in hand	14,000	6,000
	2,10,000	2,76,000		2,10,000	2,76,000

Particulars of Bat Ltd.:

(1) This company was formed on 1.4.2008.

(2) It acquired the shares of Ball Ltd. as under :

Date of Acquisition	No. of Shares	Cost Rs.
1.4.2008	8,000	1,10,000
31.7.2008	6,000	86,000

(3) The shares purchased on 31.7.2008 are ex-dividend and ex-bonus from existing holders.

(4) On 31.7.2008 dividend at 10% was received from Ball Ltd. and was credited to Profit and Loss Account.

(5) On 31.7.2008 it received bonus shares from Ball Ltd. in the ratio of one share on every four shares held.

(6) Bat Ltd. incurred an expenditure of Rs. 500 per month on behalf of Ball Ltd. and this was debited to the Profit and Loss Account of Bat Ltd., but nothing has been done in the books of Ball Ltd.

(7) The balance in the Profit and Loss Account as on 31.3.2009 included Rs. 36,000 being the net profit made during the year.

(8) Dividend proposed for 2008-09 at 10% was not provided for as yet.

Particulars of Ball Ltd:

(1) The balance in the Profit and Loss Account as on 31.3.2009 is after the issue of bonus shares made on 31.7.2008.

(2) The net profit made during the year is Rs. 24,000 including Rs. 6,000 received from insurance company in settlement of the claim towards loss of stock by fire on 30.06.2008 (Cost Rs. 10,800 included in opening stock).

(3) Dividend proposed for 2008-09 at 10% was not provided for in the accounts.

Prepare the Consolidated Balance Sheet of Bat Ltd. as on 31.3.2009.

Answer 23.

Liabilities	Amount Rs.	Assets	Amount Rs.
Share Capital		Stock	80,000
(Shares of Rs. 10 each)	1,60,000	Debtors	1,20,000
Minority Interest	50,800	Cash at Bank	70,000
Capital Reserve	3,040	Cash in hand	20,000
Profit and Loss Account	44,160		
Creditors	16,000		
Proposed Dividend	16,000		—
	2,90,000		2,90,000

Working Notes :

(1) Analysis of profits of Ball Ltd.

			Capital Profits Rs.	Revenue Profits Rs.
Profit and Loss Account on 1.4.2008				
(60,000 – 24,000)			36,000	
Profit for the year	24,000			
Add back: Loss by fire	4,800			
	28,800			
Less: Expenses not considered	6,000			
	22,800			
Pre-acquisition profits $= \frac{4}{12} \times 22,800 =$	7,600			
Less : Loss in pre-acquisition period =	4,800	2,800		
Post-acquisition profits $\left(\frac{8}{12} \times 22,800\right)$				15,200
			38,800	15,200
Bat Ltd.'s share (80%*)			31,040	12,160
Minority's share (20%)			7,760	3,040

$$* \frac{8,000 + 6,000 + \text{Bonus shares} \frac{8,000}{4} \text{ i.e. } 2,000}{20,000} \times 100$$

$$= \frac{16,000}{20,000} \times 100 = 80\%$$

(2) Minority interest

	Rs.
Share capital	40,000
Capital profits	7,760
Revenue profits	3,040
	50,800

(3) Cost of control

		Rs.
Face value of investments	1,60,000	
Capital profits	31,040	1,91,040
Investment in Ball Ltd.	1,96,000	
Less: Pre-acquisition dividend	8,000	(1,88,000)
Capital Reserve		3,040

(4) Profit and Loss Account – Bat Ltd.

	Rs.
Balance	50,000
Less: Pre-acquisition dividend wrongly credited	8,000
	42,000
Less: Proposed dividend	16,000
	26,000
Add: Expenses of Ball Ltd. written back	6,000
Add: Share in Ball Ltd.	12,160

Q24. From the following Balance Sheets of a group of companies and the other information provided, draw up the Consolidated Balance Sheet as on 31.3.2009. Figures given are in Rupees Lakhs :

Balance Sheets as on 31.3.2009

	X	Y	Z		X	Y	Z
Shares capital (in shares of Rs. 10 each)	300	200	100	Fixed Assets less depreciation	130	150	100
Reserves	50	40	30	Cost of investment in Y Ltd.	180	—	—
Profit and loss balance	60	50	40	Cost of investment in Z Ltd.	40	—	—
Bills payables	10	—	5	Cost of investment in Z Ltd.	—	80	—
Creditors	30	10	10	Stock	50	20	20
Y Ltd. balance	—	—	15	Debtors	70	10	20
Z Ltd. balance	50	—	—	Bills receivables	—	10	20
				Z Ltd. balance	—	10	—
				X Ltd. balance	—	—	30
	—	—	—	Cash and bank balance	30	20	10
	500	300	200		500	300	200

X Ltd. holds 1,60,000 shares and 30,000 shares respectively in Y Ltd. and Z Ltd.; Y Ltd. holds 60,000 shares in Z Ltd. These investments were made on 1.7.2008 on which date the provision was as follows:

	Y Ltd.	Z Ltd.
Reserves	20	10
Profit and loss account	30	16

- In December, 2008 Y Ltd. invoiced goods to X Ltd. for Rs. 40 lakhs at cost plus 25%. The closing stock of X Ltd. includes such goods valued at Rs. 5 lakhs.
- Z Ltd. sold to Y Ltd. an equipment costing Rs. 24 lakhs at a profit of 25% on selling price on 1.1.2009. Depreciation at 10% per annum was provided by Y Ltd. on this equipment.
- Bills payables of Z Ltd. represent acceptances given to Y Ltd. out of which Y Ltd. had discounted bills worth Rs. 3 lakhs.

- **Debtors of X Ltd. Include Rs. 5 lakhs being the amount due from Y Ltd.**
- **X Ltd. proposes dividend at 10%.**

Answer 24.

Consolidated Balance Sheet of X Ltd. and its subsidiaries Y Ltd. and Z Ltd.as at 31st March, 2009

(Rs. in lakhs)

Liabilities		Amount	Assets	Amount	
Share capital		300.00	Fixed Assets		
Minority Interest			X Ltd.	130.00	
Y Ltd.	63.08		Y Ltd.	150.00	
Z Ltd.	16.22	79.30	Z Ltd.	100.00	
Capital Reserve		13.40		380.00	
			Less: Unrealised profit	7.80	372.20
Other Reserves		81.60	Stock		
Profit and Loss Account		56.90	X Ltd.	50.00	
Bills Payables			Y Ltd.	20.00	
X Ltd.	10.00		Z Ltd.	20.00	
Y Ltd.	5.00		90.00		
	15.00		Less: Unrealised profit	1.00	89.00
Less: Mutual indebtedness	2.00	13.00	Debtors		
			X Ltd.	70.00	
Creditors			Y Ltd.	10.00	
X Ltd.	30.00		Z Ltd.	20.00	
Y Ltd.	10.00			100.00	
Z Ltd.	10.00		Less: Mutual	5.00	95.00
		50.00	indebtedness		
			Cash and Bank Balances		60.00
Less: Mutual	5.00	45.00	Bills Receivables		
indebtedness			Y Ltd.	10.00	
Current Account Balances			Z Ltd.	20.00	
X Ltd.	50.00			30.00	
Z Ltd.	15.00		Less: Mutual indebtedness	2.00	28.00
	65.00				
Less: Mutual	25.00				
indebtedness (10+30)	40.00				
Proposed Dividend		30.00			
		644.20			**644.20**

Working Notes :

(Rs. in lakhs)

		Capital Profit	Revenue Reserve	Revenue profit
(1)	Analysis of Profits of Z Ltd.			
	Reserves on 1.7.2008	10.00		
	Profit and Loss A/c on 1.7.2008	16.00		
	Increase in Reserves		20.00	
	Increase in Profit	—	—	24.00
		26.00	20.00	24.00
	Less: Minority Interest (10%)	2.60	2.00	2.40
		23.40	18.00	21.60
	Share of X Ltd.	7.80	6.00	7.20
	Share of Y Ltd.	15.60	12.00	14.40
(2)	Analysis of Profits of Y Ltd.			
	Reserves on 1.7.2008	20.00		
	Profit and Loss A/c on 1.7.2008	30.00		
	Increase in Reserves		20.00	
	Increase in Profit	—	—	20.00
		50.00	20.00	20.00
	Share in Z Ltd.	—	12.00	14.40
		50.00	32.00	34.40
	Less: Minority Interest (20%)	10.00	6.40	6.88
	Share of X Ltd.	40.00	25.60	27.52
(3)	Cost of Control			
	Investments in Y Ltd.			180.00
	Investments in Z Ltd.			120.00
				300.00
	Less: Paid up value of investments			
	in Y Ltd.	160.00		
	in Z Ltd.	90.00	250.00	
	Capital Profit			
	in Y Ltd.	40.00		
	in Z Ltd.	23.40	63.40	313.40
	Capital Reserve			13.40

		Y Ltd.	Z Ltd.
(4)	Minority Interest	**Y Ltd.**	**Z Ltd.**
	Share Capital	40.00	10.00
	Capital Profit	10.00	2.60
	Revenue Reserves	6.40	2.00
	Revenue Profits	6.88	2.40
		63.28	17.00
	Less: Unrealised profit on stock (20% of 1)	.20	
	Unrealised profit on equipment (10% of 7.8)	—	.78
		63.08	16.22
(5)	Unrealised Profit on equipment sale		
	Cost	24.00	
	Profit	8.00	
	Selling Price	32.00	
	Unrealised profit		
	$= 8 - 8 \times \frac{10}{100} \times \frac{3}{12} = 8.00 - 0.20 = 7.80$		
	Profit and Loss Account – X Ltd.		
	Balance	60.00	
	Less: Proposed Dividend	30.00	
	30.00		
	Share in Y Ltd.	27.52	
	Share in Z Ltd.	7.20	
	64.72		
	Less: Unrealised profit on equipment (90% of 7.8)	7.02	
		57.70	
	Less: Unrealised profit on stock $\left(5 \times \frac{25}{125} \times 80\%\right)$	.80	
		56.90	
(7)	Reserves – X Ltd.		
	X Ltd.	50.00	
	Share in Y Ltd.	25.60	
	Share in Z Ltd.	6.00	
		81.60	

Q25. From the following Profit and Loss Account of Kalyani Ltd., prepare a Gross Value Added Statement. Show also the reconciliation between Gross Value Added and Profit before Taxation.

Profit and Loss Account for the year ended 31st March, 2009

Income

	Notes	Amount	
		(Rs. in lakhs)	(Rs.in lakhs)
Sales			206.42
Other Income			10.20
			216.62
Expenditure			
Production and Operational Expenses	1	166.57	
Administration Expenses	2	6.12	
Interest and Other Charges	3	8.00	
Depreciation		5.69	186.38
Profit before Taxes			30.24
Provision for taxes			3.00
			27.24
Investment Allowance Reserve Written Back			0.46
Balance as per Last Balance Sheet			1.35
			29.05
Transferred to:			
General Reserve		24.30	
Proposed Dividend		3.00	27.30
Surplus Carried to Balance Sheet		1.75	
		29.05	

Notes:

(1) Production and Operational Expenses

		(Rs.in lakhs)
Increase in Stock		30.50
Consumption of Raw Materials		80.57
Consumption of Stores+		5.30
Salaries, Wages, Bonus and Other Benefits	12.80	
Cess and Local Taxes		3.20
Other Manufacturing Expenses		34.20
		166.57

(2) Administration expenses include inter-alia Audit fees of Rs. 1 lakh, Salaries and commission to directors Rs. 2.20 lakhs and Provision for doubtful debts Rs. 2.50 lakhs.

(3) Interest and Other Charges:

	(Rs.in lakhs)
On Fixed Loans from Financial Institutions	3.90
Debentures	1.80
On Working Capital Loans from Bank	2.30
	8.00

Answer 25.

Kalyani Ltd.

Value Added Statement for the year ended 31st March, 2009

	Rs.in lakhs	Rs. in lakhs	%
Sales		206.42	
Less: Cost of bought in material and services:			
Production and operational expenses	150.57		
Administration expenses	3.92		
Interest on working capital loans	2.30	156.79	
Value Added by manufacturing and trading activities		49.63	
Add: Other income		10.20	
Total Value Added		59.83	

Application of Value Added:

To Pay Employees:			
Salaries, Wages, Bonus and other benefits		12.80	21.39
To Pay Directors:			
Salaries and Commission		2.20	3.68
To Pay Government:			
Cess and Local Taxes	3.20		
Income Tax	3.00	6.20	10.36
To Pay Providers of Capital:			
Interest on Debentures	1.80		
Interest on Fixed Loans	3.90		
Dividend	3.00		
		8.70	14.54
To Provide for maintenance and Expansion of the company:			
Depreciation	5.69		
General Reserve (24.30 – 0.46)	23.84		
Retained profit (1.75 – 1.35)	0.40	29.93	50.03
		59.83	100.00

Reconciliation between Total Value Added and Profit Before Taxation :

		(Rs. in lakhs)	(Rs. in lakhs)
Profit before tax			30.24
Add back:			
Depreciation		5.69	
Salaries, Wages, Bonus and other benefits		12.80	
Directors' Remuneration	2.20		
Cess and Local Taxes	3.20		
Interest on Debentures	1.80		
Interest on Fixed Loans	3.90		29.59
Total Value Added			59.83

Q26. From the following Profit and Loss Account of X Limited, prepare Gross Value Added Statement and show the reconciliation between Gross Value Added and Profit before taxation: Profit and Loss Account for the year ended 31st March, 2009

Income	(Rs. in lakhs)	(Rs. in lakhs)
Sales		800
Other Income		50
		850
Expenditure		
Production and Operational Expenses	600	
Administrative Expenses	30	
Interest and Other Charges	30	
Depreciation	20	680
Profit before taxes		170
Provision for taxes		30
		140
Balance as per last Balance Sheet		10
		150
Transferred to:		
General Reserve		80
Proposed Dividend		20
Surplus carried to Balance Sheet		50
		150

Break-up of some of the Expenditure is as follows:

Production and Operational Expenses:	
Consumption of Raw Materials and Stores	320
Salaries, Wages and Bonus	60
Cess and Local Taxes	20
Other Manufacturing Expenses	200
	600
Administrative Expenses:	
Audit Fee	6
Salaries and Commission to Directors	8
Provision for Doubtful Debts	6
Other Expenses	10
	30
Interest and other Charges:	
On Working Capital Loans from Bank	10
On Fixed Loans from ICICI	15
On Debentures	5
	30

Answer 26.

X Limited

Gross Value Added Statement for the year ended 31st March, 2009

	Rs. in lakhs	Rs. in lakhs
Sales		
Less: Cost of bought in material or services:		800
Production and Operational Expenses (320 + 200)	520	
Administrative Expenses (6 + 6 +10)	22	
Interest on working capital loans	10	552
Value added by manufacturing and trading activities		248
Add: Other Income		50
Total Value Added		298

Application of Value Added:

				%
To	Pay Employees:			
	Salaries, Wages and Bonus		60	20.14
To	Pay Directors:			
	Salaries and Commission		8	2.68
To	Pay Government:			
	Cess and Local taxes	20		
	Income Tax	30	50	16.78

To	Pay Providers of Capital:			
	Interest on Debentures	5		
	Interest on Fixed Loans	15		
	Dividend	20	40	13.42
To	Provide for Maintenance and Expansion			
	of the Company: Depreciation	20		
	General Reserve	80		
	Retained Profit (50 – 10)	40	140	46.98
			298	100.00

Reconciliation between Gross Value Added and Profit before Taxation

	Rs. in lakhs	Rs. in lakhs
Profit before tax		170
Add back:		
Depreciation	20	
Salaries, Wages and Bonus	60	
Directors' Remuneration	8	
Cess and Local Taxes	20	
Interest on Debentures	5	
Interest on Fixed Loans	15	128
Total Value Added		298

Q27. What are the advantages of preparation of Value Added (VA) statements?

Answer 27.

Various advantages of preparation of Value Added (VA) Statements are as under:

1. Reporting on VA improves the attitude of employees towards their employing companies. This is because the VA statement reflects a broader view of the company's objectives and responsibilities.
2. VA statement makes it easier for the company to introduce a productivity linked bonus scheme for employees based on VA. The employees may be given productivity bonus on the basis of VA / Payroll Ratio.
3. VA based ratios (e.g. VA / Payroll, taxation / VA, VA / Sales etc.) are useful diagnostic and predictive tools. Trends in VA ratios, comparisons with other companies and international comparisons may be useful.
4. VA provides a very good measure of the size and importance of a company. To use sales figure or capital employed figures as a basis for company's rankings can cause distortion. This is because sales may be inflated by large bought-in expenses or a capital-intensive company with a few employees may appear to be more important than a highly skilled labour–intensive company.

5. VA statement links a company's financial accounts to national income. A company's VA indicates the company's contribution to national income.
6. VA statement is built on the basic conceptual foundations which are currently accepted in balance sheets and income statements. Concepts such as going concern, matching, consistency and substance over form are equally applicable to VA statement.

Q28. (a) Explain the concept of 'Economic value added' (EVA for short) and its uses.

(b) What is economic value added and how is it calculated? Discuss.

Answer 28.

(a) Economic Value Added (EVA) for short, is primarily a benchmark to measure earnings efficiency. Though the term "Economic Profit" was very much there since the inception of "Economics", Stern Stewart & Co., of USA has got a registered Trade Mark for this by the name "EVA", an acronym for Economic Value Added.

EVA as a residual income measure of financial performance, is simply the operating profit after tax less a charge for the capital, equity as well as debt, used in the business. EVA includes both profit and loss as well as balance sheet efficiency as well as the ROCE, or ROE.

In addition, EVA is a management tool to focus managers on the impact of their decisions in increasing shareholders' wealth. These include both strategic decisions such as what investments to make, which businesses to exit, what financing structure is optimal; as well as operational decisions involving trade-offs between profit and asset efficiency such as whether to make in house or outsource, repair or replace a piece of equipment, whether to make short or long production runs etc.

Most importantly the real key to increasing shareholder wealth is to integrate the EVA framework in four key areas; to measure business performance; to guide managerial decision making; to align managerial incentives with shareholders' interests; and to improve the financial and business literacy throughout the organisation.

To better align managers interests with Shareholders – the EVA framework needs to be holistically applied in an integrated approach – simply measuring EVAs is not enough it must also become the basis of key management decisions as well as be linked to senior management's variable compensation.

(b) Economic Value Added (EVA) is primarily a benchmark to measure earnings efficiency. EVA as a residual income measure of financial performance is simply the operating profit after tax less a charge for the capital employed, equity as well as debt, used in the business.

Mathematically EVA= OPBT - Tax - (TCE × COC)

Where :

OPBT = Opening Profit Before Tax

TCE = Total Capital Employed

COC = Cost of Control

Because EVA includes both profit and loss as well as balance sheet efficiency as well as the opportunity cost of investor capital - it is better linked to changes in shareholders wealth and is superior to traditional financial measures such as PAT or percentage of return measures such as ROCE or ROE.

EVA, additionally, is a tool for management to focus on the impact of their decisions in increasing shareholders wealth. These include both strategic decisions such as what investments to make, which business to exit, what financing structure is optimal; as well as operational decisions involving trade-offs between profit and asset efficiency such as whether to make inhouse or outsource, repair or replace an equipment, whether to make short or long production runs etc.

Most importantly the real key to increasing shareholders wealth is to integrate EVA framework in four key areas, viz., to measure business performance, to guide managerial decision making, to align managerial incentives with the shareholders' interests and to improve the financial and business literacy throughout the organisation.

To better align managers interests with shareholders' - the EVA framework needs to be holistically applied in an integrated approach - simply measuring EVA is not enough; it must also become the basis of key management decisions as well as be linked to senior management's variable compensation.

However, EVA as a strategic tool has the following limitations:

1. Not easy to use; too complicated for small businesses.
2. Recommends inexpensive debts in order to reduce the cost of capital.
3. A passive tool, measures past performance.

Q29. The following information is available of a concern; calculate E.V.A:

Debt capital 12%	Rs. 2,000 crores
Equity capital	Rs. 500 crores
Reserve and surplus	Rs. 7,500 crores
Capital employed	Rs. 10,000 crores
Risk-free rate	9%
Beta factor	1.05
Market rate of return	19%
Equity (market) risk premium	10%
Operating profit after tax	Rs.2,100 crores
Tax rate	30%

Answer 29.

E.V.A. = NOPAT – COCE

NOPAT = Net Operating Profit after Tax

COCE = Cost of Capital Employed

COCE = Weighted Average Cost Of Capital ´ Average Capital Employed

= WACC ´ Capital Employed

Debt Capital		Rs.2,000 crores
Equity capital 500 + 7,500	=	Rs.8,000 crores
Capital employed	=	2,000+8,000 = Rs.10,000 crores
Debt to capital employed	=	$\frac{2,000}{10,000} = 0.20$

Equity to Capital employed $= \frac{8,000}{10,000} = 0.80$

Debt cost before Tax	12%	
Less:	Tax (30% of 12%)	3.6%
Debt cost after Tax	8.4%	

According to Capital Asset Pricing Model (CAPM)

Cost of Equity Capital = Risk Free Rate + Beta ´ Equity Risk Premium

Or

= Risk Free Rate + Beta (Market Rate – Risk Free Rate)

= 9 + 1.05 × (19-9)

= 9 + 1.05 × 10 = 19.5%

WACC = Equity to CE x Cost of Equity capital + Debt to CE x Cost of debt

= 0.8×19.5% + 0.20× 8.40%

= 15.60% + 1.68% = 17.28%

COCE = WACC × Capital employed

= 17.28% × 10,000 crores = 1728 crores

E.V.A. = NOPAT – COCE

= Rs. 2,100 – Rs. 1,728 = Rs. 372 crores

Q30. (a) "The content of corporate social report is essentially based on social objectives." Discuss.

(b) Enumerate the major heads identified for corporate social reporting purposes.

(c) rite short note on Corporate Social Reporting.

Answer 30.

(a) The content of Corporate Social Report is essentially based on the social objectives. Brummet identified five areas wherein social objectives can be traced out, namely, Net Income Contribution, Human Resource Contribution, Public Contribution, Environmental Contribution and Product or Service Contribution.

In view of the social objectives, the importance of earning objective is not understated, rather attainment of social objectives is dependent on earning objective. A sick business entity becomes liability to the society and sustains social costs instead of generating social benefits.

Human Resource Contribution is the indicator of the impact of organisational activities (viz. pay and allowances, perks and incentives, recruitment, training and development, placement, promotion and transfer, welfare measure, etc.) on people of the organisation. Public Contribution is the indicator of general philanthropy in the cultural and social welfare programmes and contribution to national exchequer by way of tax and duties.

Industrial activity is supposed to consume irreplaceable resources and produces solid wastes. By this process it pollutes air and water, causes noise and spoils the environment. These are termed as negative social effects. The corporate social objective is the abatement of such negative effect. It is covered by environmental contribution.

Lastly, the Product or Service Contribution covers the qualitative aspects of the organisation's product or service. It includes quality guarantee, redressal of customers' grievances, honest exposure in advertisement etc.

Although Brummet covered wide range of objectives, still these are not essentially exhaustive. Social objectives are determined by socio-economic conditions of a country. It is difficult to set universal list of social objectives to be pursued by the corporate sector. For example, in India, regional imbalance, unemployment, reservation for weaker sections of the population, scarcity of foreign exchange, energy deficit, population pressure and illiteracy are some of the widely accepted socio-economic problems. And obviously the general expectation is that the corporate sector will positively contribute to such socio-economic problems. Since the socio-economic problems of a country change over time or the priority attached to a problem shifts. Brummet's over simplified set of contributions should be suitably moulded to fit in the perspective of socio-economic problems of a country.

(b) Considering the major socio-economic problems of the country, eight major heads may be identified for Social Reporting purposes:

I. Employment Opportunities.
II. Foreign Exchange Transactions
III. Energy Conservation.
IV. Research and Development.
V. Contribution to Government Exchequer.
VI. Social Projects
VII. Environmental Control.
VIII. Consumerism.

I. Creation of employment opportunities during the year may be classified into opportunities in India and opportunities abroad. In India employment may be created either by expansion/ diversification in backward or other areas. However, employment protection by absorption of sick units may also be treated as employment opportunities. Moreover, the corporate enterprise may create new openings abroad by adopting foreign projects. In all such cases, quantitative information needs to be disclosed giving break-up of SC/ST persons, physically handicapped persons, women and other workers appointed during the year. Tax advantage or subsidy received for establishing industrial units in backward areas or absorption of sick units should be disclosed properly. If the corporate enterprise follows human resource accounting system, it may show human assets created during the year and costs incurred for such purpose.

II. In view of the scanty foreign exchange reserve, it is desirable to disclose foreign exchange transactions in details. Foreign exchange inflows occur by exports or earnings from foreign projects. Also saving in foreign exchange is equivalent to foreign exchange inflows. An enterprise can save foreign exchange by import substitution and replacement of foreign technology/ technician. Foreign exchange outflows are caused by purchase of' raw materials/spares, plant and machinery capital repayment, payment of dividend and interest. It is desirable to report inflows and outflows for each currency separately and a summary statement in Indian currency. Any tax advantage/export subsidy received for foreign exchange earnings should be disclosed as an item of social cost.

III. Energy purchased/generated and energy consumed per unit of standard product are to be reported along with consumption norm of the industry. Energy Audit Reports prepared by BICP may be followed for industry norms wherever applicable. Positive/negative variation in energy consumption should be reported along with reasons therefor.

IV. Recurring/non-recurring cost incurred for research and development is to be reported along with results. If possible, effect of research and development activities may be quantified in terms of cost saved/profit added. Any tax advantage/subsidy received is to be reported as social cost incurred along with the generation of social benefits from research and development.

V. Contribution to Government exchequer by way of sales tax, income tax, excise, custom and other duties needs to be reported as an item of social benefits.

VI. Contribution to social projects may be further classified into direct involvement of corporate enterprise and donations to different organisations. Social projects like construction of road, establishment of school, college, research institute, hospital, stadium, etc. may be earmarked alongwith the categories of beneficiaries and cost involved.

In case of donation to any organisation, the nature of the organisation may be stated along with the tax advantage received by way of such donations.

(Contribution of the corporate enterprise for development of sports and games, cultural matters and self-employment programmes may be reported as creation of social benefit).

VII. Negative social effect caused by the corporate enterprise may be quantified stating use of irreplaceable resources and nature of pollution caused. Action taken and cost involved for pollution control should be reported as an item of social benefit.

VIII. Failures in terms of complaints received against improper quality, poor service etc. may be reported under social costs. Action taken and cost involved for undertaking quality control and customers' service should be reported under social benefits.

(c) Corporate Social Reporting is the information communique with respect to discharge of social responsibilities of corporate entity. The transition in accounting function from historical cost based profitability accounting to social responsibility accounting is a good fit to the present-day data requirement of the "Users of accounts".

The content of Corporate Social Report is essentially based on the social objectives, namely Net Income Contribution, Human Resource Contribution, Public Contribution, Environmental Contribution and Product or Service Contribution.

Considering the major socio-economic problems of the country, eight major heads can be identified for social reporting purpose:

(i) Employment Opportunities;

(ii) Foreign Exchange Transactions;

(iii) Energy Conservation;

(iv) Research and Development;

(v) Contribution to Government Exchequer;

(vi) Social Projects;

(vii) Environmental Control;

(viii) Consumerism.

Initially, it is difficult to express social costs incurred by a corporate enterprise and social benefits generated in money terms. Until suitable methodologies are available for conversion of social cost-benefit in money terms, it is desirable to begin with descriptive social report. Further research is necessary in this area either to improve heads of corporate social reporting in the context of dynamic socio-economic environment.

Q31. Write short notes on :

(a) Jaggi and Lau model on valuation on group basis of Human Resources.

(b) Opportunity cost (HRA).

(c) Human Resource Accounting.

Answer 31.

(a) According to Jaggi and Lau Model, proper valuation of human resources is not possible unless the contributions of individuals as a group are taken into consideration. A group refers to homogeneous employees whether working in the same department or division of the organisation or not. An individual's expected service tenure in the organisation is difficult to predict but on a group basis it is relatively easy to estimate the percentage of people in a group likely to leave the organisation in future. This model attempted to calculate the present value of all existing employees in each rank. Such present value is measured with the help of the following steps:

(i) Ascertain the number of employees in each rank.

(ii) Estimate the probability that an employee will be in his rank within the organisation or terminated/promoted in the next period. This probability will be estimated for a specified time period.

(iii) Ascertain the economic value of an employee in a specified rank during each time period.

(iv) The present value of existing employees in each rank is obtained by multiplying the above three factors and applying an appropriate discount rate.

Jaggi and Lau simplified the process of measuring the value of human resources by considering a group of employees as valuation base. But in the process, they ignored the exceptional qualities of certain skilled employees. The performance of a group may be seriously affected in the event of exit of a single individual.

(b) **Opportunity Cost:** It is one of the Economic value models used for measurement and valuation of Human assets. As per this model, opportunity cost is the value of an employee in his alternative use. This opportunity cost is used as a basis for estimating the value of Human resources. Opportunity cost value may be established by competitive bidding within the firm so that in effect, Managers must bid for any scarce employee. A Human asset will have a value only if it is a scarce resource, that is, when its employment in one division denies it to another division. This method excludes employees of the type of which can be readily hired from outside the firm. Also, it is in very rare cases that managers would like to bid for an employee.

(c) **Human Resource Accounting (HRA)** is an attempt to identify, quantify and report investments made in human resources of an organization. Leading public sector units like OIL, BHEL, NTPC and SAIL etc. have started reporting human resources in their annual reports as additional information. Although human beings are considered as the prime mover for achieving productivity, and are placed above technology, equipment and money, the conventional accounting practice does not assign significance to the human resource. Human resources are not thus recognized as 'assets' in the Balance Sheet. While investments in human resources are not considered as assets and not amortised over the economic service life, the result is that the income and expenditure statement comprising current revenue and expenditure gives a distorted picture of the real affairs of the organization.

Accountants have been severely criticized by the Behavioural Scientists for their failure to value human resources, as this has come out as a handicap for effective management.

Human resource accounting provides scope for planning and decision making in relation to proper manpower planning. Also, such accounting can bring out the effect of various new rules, procedures and incentives relating to work force, and in turn, can act as an eye opener for modifications of existing statutes and laws.

Q32. Prepare a segmental report for publication in Glorified Ltd. from the following details of the company's three divisions and the head office:

	Rs. ('000)
Forging Shop Division	
Sales to Bright Bar Division	4,575
Other Domestic Sales	90
Export Sales	6,135
	10,800
Bright Bar Division	
Sales to Fitting Division	45
Export Sales to Rwanda	300
	345
Fitting Division	
Export Sales to Maldives	270

Particulars	**Head Office Rs. ('000)**	**Forging Shop Division Rs. ('000)**	**Bright Bar Division Rs. ('000)**	**Fitting Division Rs. ('000)**
Pre-tax operating result		240	30	(12)
Head office cost reallocated		72	36	36
Interest costs		6	8	2
Fixed assets	75	300	60	180
Net current assets	72	180	60	135
Long-term liabilities	57	30	15	180

Answer 32.

Glorified Ltd.
Segmental Report

(Rs.'000)

Particulars	Divisions Forging shop	Bright Bar	Fitting	Inter Segment Eliminations	Consolidated Total
Segment revenue					
Sales:					
Domestic	90	—	—	—	90
Export	6,135	300	270	—	6,705
External Sales	6,225	300	270	—	6,795
Inter-segment sales	4,575	45	—	4,620	—
Total revenue	10,800	345	270	4,620	6,795
Segment result (given)	240	30	(12)		258
Head office expenses					(144)
Operating profit					114
Interest expense					(16)
Profit before tax					98
Information in relation to assets and liabilities:					
Fixed assets	300	60	180	—	540
Net current assets	180	60	135	—	375
Segment assets	480	120	315	—	915
Unallocated corporate assets (75+72)	—	—	—	—	147
Total assets					1,062
Segment liabilities	30	15	180	—	225
Unallocated corporate liabilities					57
Total liabilities					282

Sales Revenue by Geographical Market

(Rs.'000)

	Home Sales	Export Sales (by forging shop division)	Export to Rwanda	Export to Maldives	Consolidated Total
External sales	90	6,135	300	270	6,795

Q33. (a) What are derivatives and what are its characteristics?

(b) Explain currency options related to foreign exchange.

(c) Write short note on Interest Rate Swaps.

Answer 33.

(a) Derivative is a product whose value is derived from the value of one or more basic variables, called bases (underlying asset, index or reference rate), in a contracted manner. The underlying asset can be equity, forex, commodity or any other asset. For example, farmers may wish to sell their harvest of wheat at a future date to eliminate the risk of a change in prices by that date. Such a transaction is an example of a derivative. The price of the derivative is driven by the spot price of wheat which is the "underlying asset".

Derivative financial instruments can either be on the balance-sheet or off the balance sheet and include options contract, interest rate swaps, interest rate flows, interest rate collars, forward contracts, futures etc. A derivative instrument is therefore a financial instrument or other contract with the following three characteristics:

(i) It has one or more underlying and one or more notional amounts or payments provisions or both. These terms determine the amount of settlement or settlements and in some cases, whether or not settlement is required;

(ii) It requires no initial net investment or an initial net investment that is smaller than what is required for similar responses to changes in market factors.

(iii) Its terms require or permit net settlement; it can readily be settled net by means outside the contract or it provides for delivery of an asset that puts the recipient in a position not substantially different from net settlement.

Accounting for foreign exchange derivatives is guided by AS 11 (Revised 2003). The ICAI has also issued a Guidance Note dealing with the accounting procedures to be adopted while accounting for Equity Index Options and Equity Stock Options.

(b) Currency Options give the client the right, but not the obligation, to buy/sell a specific amount of currency at a specific price on a specific date. Currency options provide a tool for hedging foreign exchange risk arising out of the firm's operations. Currency options enable the business house to remove downside risk without limiting the upride potential. Options can be put option or call option. A put option is a contract that specifies the currency that the holder has the right to sell. A call option is a contract that specifies the currency that the holder has the right to buy.

(c) Interest rate swap can be defined as a financial contract between two parties (called counter parties) to exchange on a particular date in the future, one series of cash flows (fixed interest) for another series of cash flows (variable or floating interest) in the same currency on the same principal (an agreed amount called notional principal) for an agreed period of time. The contract will specify the interest rates, the benchmark rate to be followed, the notional principal amount for the transaction, etc. Interest rates are of two types, fixed interest rates and floating rates which vary according to changes in a standard benchmark interest rate. An investor holding a security which pays a floating interest rate is exposed to interest rate risk. The investor can manage this risk by entering into an interest rate swap.

Q34. On 24th January, 2009 Chinnaswamy of Chennai sold goods to Watson of Washington, U.S.A. for an invoice price of $40,000 when the spot market rate was Rs.44.20 per US $. Payment was to be received after three months on 24th April, 2009. To mitigate the risk of loss from decline in the exchange-rate on the date of receipt of payment, Chinnnaswamy immediately acquired a forward contract to sell on 24th April, 2009 US $ 40,000 @ Rs. 43.70. Chinnaswamy closed his books of account on 31st March, 2009 when the spot rate was Rs. 43.20 per US $. On 24th April, 2009, the date of receipt of money by Chinnaswamy, the spot rate was Rs. 42.70 per US $.

Pass journal entries in the books of Chinnaswamy to record the effect of all the above mentioned effects.

Answer 34.

Journal Entries in the books of Chinnaswamy

2009			Rs.	Rs.
Jan. 24	Watson	Dr.	17,68,000	
	To Sales Account			17,68,000
	(Credit sales made to Watson of Washington, USA for $40,000 recorded at spot market rate of Rs. 44.20 per US $)			
" "	Forward (Rs) Contract Receivable Account	Dr.	17,48,000	
	Deferred Discount Account	Dr.	20,000	
	To Forward ($) Contract Payable			17,68,000
	(Forward contract acquired to sell on 24th April, 2009 US $40,000 @ Rs.43.70)			
March 31	Exchange Loss Account	Dr.	40,000	
	To Watson			40,000
	(Record of exchange loss @ Re.1 per $ due to market rate becoming Rs.43.20 per US $ rather than Rs.44.20 per US $)			
" "	Forward ($) Contract Payable	Dr.	40,000	
	To Exchange Gain Account			40,000
	(Decrease in liability on forward contract due to fall in exchange rate)			
" "	Discount Account	Dr.	14,667	
	To Deferred Discount Account			14,667
	(Record of proportionate discount expense for 66 days out of 90 days)			

Contd...

April 24	Bank Account Exchange Loss Account To Watson (Receipt of $40,000 from Watson, USA customer @ Rs.42.70 per US $; exchange loss being Rs.20,000)	Dr. Dr.	17,08,000 20,000	 17,28,000
" "	Forward ($) Contract Payable Account To Exchange Gain Account To Bank Account (Settlement of forward contract by payment of $40,000)	Dr.	17,28,000	 20,000 17,08,000
" "	Bank Account To Forward (Rs.) Contract Receivable (Receipt of cash in settlement of forward contract receivable)	Dr.	17,48,000	 17,48,000
" "	Discount Account To Deferred Discount Acount (Recording of discount expense for 24 days: $Rs.\ 20,000 \times \frac{24\ days}{90\ days} = Rs.\ 5,333$	Dr.	5,333	 5,333

Q35. Write a short notes on:

(a) Accounting issues involved in Environmental Accounting.

(b) Environmental Accounting.

Answer 35.

(a) Major accounting issues involved in environmental accounting can be explained as follows:

(i) Distinction between environmental expenditure and normal business expenditure: Many new machines may incorporate state-of-the-art environmental technology and accordingly, a portion of such capital costs and also the running and maintenance expenditure may be treated as environment related expenditure. It is necessary to frame guidelines indicating whether the reporting entity should properly allocate the capital and revenue expenditures between environmental expenditure and normal business expenditure.

(ii) Capitalisation of environmental expenditures vis-a-vis expensing them during the current accounting period: Environmental protection costs relating to prior periods and current period are generally very high and if expensed in one year as and when a reporting entity is recoursed to and/or persuaded to follow environmental accounting, the adverse impact in EPS is a major concern. Accordingly many Western Corporations prefer to capitalise environment costs instead of immediate expensing and adopt an amortisation policy

extending upto 10 years. Although this accounting practice has no theoretical support and rather contradicts the well established accounting concept of "prudence", it is considered as a practical solution to off-load burden of accumulated environmental costs without abruptly disturbing the cash flows attributable to the lenders, Government and finally to the shareholders. However, recognition of environmental costs should not necessarily be restricted to the expenses accrued in view of the applicable environmental laws. It should be guided by ethical consideration.

(iii) Recognition of environment related contingent liabilities: Environmental contingent liabilities are a matter of increasing concern throughout the world. Recognising a liability of hazardous waste remediation frequently depends on the ability to estimate remediation costs reasonably.

In fact, identification and measurement of contingent liabilities are highly debatable accounting aspects. The United Nations Conference on Environment and Development (UNCTAD) papers raise the basic question why environmental contingencies should not be merged with other business contingencies. There is an urgent need for tightening the reporting rules on contingencies incorporating specific requirements for disclosure of environmental contingencies along with other contingencies.

(b) The term 'environment' includes everything in all its manifest forms, on the earth, beneath the earth and above the earth. A business enterprise takes support of social and ecological system in order to maximize wealth. Economic activity, social welfare and a diverse environment, all are linked and ultimately depend on each other. The functioning of an enterprise may have some favourable and some adverse effects on the environment. Hence, it is felt that there is a need for maintaining accounts of the effects of activities of business entity on the environment. Environmental accounting can be defined as a system (methodology) for measuring environmental performance and communicating the results of these measurements to users. It helps in presenting the utilization of natural resources by an enterprise, the costs incurred to use them and the income earned therefrom in a transparent manner. Environmental accounting, entirely a new concept, is a faithful attempt to identify the resources exhausted and the costs rendered reciprocally to the enterprise by a business corporation. Thus environmental accounting stands for recording and documenting environmental performance to facilitate effectiveness of environmental management system with reference to compliance, safety and quality control. It provides a data base for taking corrective steps and future action for developing organisation's environmental strategy and for identifying environmentally based opportunities for gaining an edge over one's competitors. If proper environmental accounting system is established, the enterprise will be able to anticipate environmental damage and therefore can prevent it from happening.

Of course environmental accounting is still in an early stage of evolution and it is being groomed under the voluntary leadership of a variety of enterprises around the world. Recognising the importance of protecting and preserving the environment, a number of laws have been enacted throughout the world.

Q36. Explain the concept of fund theory and fund based accounting.

Answer 36.

Fund theory and fund based accounting: Although, the profit motive is the driving force for any business entity, there are certain organisations which are run without profit motive. Such

organisations may be governmental institutions or any non-profit institutions like colleges, universities, charitable hospitals etc. The accounting for these not-for profit entities is primarily based on the fund theory. The fund theory is based on the equation - Assets = Restrictions on assets. Assets represent prospective services to the fund and liabilities represent restrictions against the assets of the fund. For example, in case of a university, the most commonly used specific funds are endowment funds, development funds etc. Each of these funds has its specific assets restricted for particular purposes. Under the fund theory, the balance sheet is considered an 'inventory statement' of assets and those restrictions applicable to the assets. Revenues represent an increase in assets into the fund that are completely free of equity restrictions other than the final restriction imposed by the residual equity. The residual equity represents a final restriction on the assets and establishes the equality of assets and equities. Expenses represent the release of services for designated purposes specified in the objective of the fund. Thus, the fund theory calls for fund based accounting rather than entity based accounting.

A fund may be defined as an accounting entity "with a self balancing set of accounts regarding cash and/or other resources together with all related liabilities and residual equities or balances, and changes therein, which are segregated for the purpose of carrying specific activities or attaining certain objectives in accordance with special regulations, restrictions or limitations". Thus, every fund is aimed at fulfilling some purpose and the services embodied in the assets are the primary means to achieve that purpose. Fund based accounting essentially involves preparation of financial statements fundwise and consolidation of those statements to represent the financial results/position of the organisation as a whole.

Q37. What are the special features of accounting for Educational Institutions?

Answer 37.

Special Features of Accounting for Educational Institutions: An educational institution is generally not run for profit. Its, administrators, as custodians of public funds, are accountable of their proper expenditure for educational purpose. The marked difference between commercial accounting and that for educational institutions is that the former places emphasis on proper ascertainment of profits, while the latter is more generally concerned with exercising control over expenditure so as to conform to the stipulated norms and to the academic objectives of the institution to which it relates.

In the case of institutions like colleges and universities, separate ledgers are maintained for each fund. Funds may be broadly classified into two categories - Revenue Funds and Specific Funds. Revenue Funds may be further classified as Unrestricted Fund and Restricted Fund. Specific Funds are Endowment Funds, Annuity and Life Income Funds, Development Funds etc. Separate balance sheet is prepared for each fund and a statement of activity (popularly known, as Income and Expenditure Account) is prepared for only revenue funds- both restricted and unrestricted. Finally, each individual balance sheet is consolidated to get a general balance sheet of the institution as a whole.

Revenue Funds- Restricted and Unrestricted: Revenue funds essentially record normal revenue transactions. However, the use of revenue fund may be restricted or unrestricted. In the case of restricted funds, income is recognised to the extent of expenditure incurred. The accounting basis of the unrestricted fund is the accrual method as used for commercial entities.

There may be transfers out of revenue funds to specific funds and vice-versa. Some transfers are mandatory and some are non-mandatory.

Both mandatory and non-mandatory transfers are reported separately in the financial statements of the revenue funds.

Specific Funds: Specific funds are earmarked for well defined purposes. Contributions and transfers arc directly credited to respective fund balances. Expendable resources are transferred to revenue funds except for capital outlay and debt retirement which are accounted for in development or asset fund and loan fund respectively. For the specific funds no statement of income is prepared.

However a statement is prepared showing the movements in fund balances. The features of certain important specific funds are dis-cussed below.

(a) **Endowment Funds:** Incomes from these funds usually are transferred to another fund where it may be expended. Interest revenue out of such fund is accrued at the end of accounting year. The fund is usually invested in some securities and such invest-ment is valued at cost price. If the income out of such investment is available for unrestricted purposes it is recognised in the unrestricted fund. On the other hand if the income is to be used for some specific purpose it is transferred to that specific fund. The only time, the investment income is recognised in the endowment fund is when the terms of agreement specify that the income must be added to the endow-ment principal.
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(b) **Loan Funds:** Loan funds account for resources that may be loaned to faculty or staff. No revenue or expense accounts are used in the loan fund. All transactions affecting fund balance are recorded directly to fund balance. Interest on loan is credited to the fund balance on accrual basis. Investment income is also accrued. Administra-tion and collection costs relating to granting and recovery of loans are directly charged to this fund. Any bad debt or provision for doubtful loans are also charged to this fund.

(c) **Annuity and Life Income Funds:** These funds account for resources that are given to a not for profit organisation provided that the organisation agrees to make periodic payments to a designated recipient. In the case of annuity funds, the amount of periodic payment is fixed whereas payments vary with the amount of income earned in the case of life income funds.

(d) **Development Funds:** These funds are utilised for developmental purposes like ac-quisition of building and equipments, major repairs to fixed assets etc. Separate fund may be maintained for each developmental activity. Alternatively a combined development fund may be maintained to account for all acquisitions and/or construc-tion of fixed assets. Any expenditure incurred for the purpose of construction or acquisition of building, laboratory etc. are met out of this fund and the asset is recognised in the general balance sheet. Consequently that portion of the fund which has been utilised for the acquisition or construction of the asset should be transferred to unrestricted fund. Depreciation on these fixed assets should be shown as part of operating expenses of unrestricted revenue fund.

To sum up the following statements are to be prepared to get a consolidated picture the organisation as a whole:

(a) Income and Expenditure Account for revenue funds.

(b) Statement showing changes in fund balances.

(c) Balance Sheet of individual funds.

(d) General Balance Sheet.

Q38. A University receives two grants % one from the Ministry of Human Resources to be used for Aids Research. This grant is for Rs. 45,00,000, which includes Rs. 3,00,000 to cover indirect expenses incurred in administering the grant. The second grant of Rs. 35,00,000 received from a reputed Trust is to be used to set up a centre to conduct seminars on Aids related matters from time to time. During the year, it also received Rs. 5,00,000 worth of equipment donated by a well wisher to be used for Aids research. During the year 2007-2002, the University spent Rs. 32,25,000 of the government grant and incurred Rs. 3,00,000 overhead expenses. Rs. 28,00,000 were spent from the grant received from the Trust. Show the necessary Journal Entries.

Answer 38.

Journal Entries

			Dr. Rs.	Cr Rs.
(i)	Bank A/c To Revenue Fund (Restricted) A/c (To record grants received from the Government Department and Private organisation)	Dr.	80,00,000	 80,00,000
(ii)	Expenses A/c To Bank A/c (To account for Rs.32,25,000 spent from out of Government grant and Rs.28,00,000 from out of Private grant)	Dr.	60,25,000	 60,25,000
(iii)	Equipment A/c To Restricted Revenue Fund A/c (To record the receipt of donation of assets from a well wisher)	Dr.	5,00,000	 5,00,000
(iv)	Revenue Fund (Restricted) A/c To Income (Govt. grant) A/c To Income (Private grant) A/c (To recognise revenue)	Dr.	60,25,000	 32,25,000 28,00,000
(v)	Revenue Fund (Restricted) A/c To Bank A/c (To account for overhead expenses incurred)	Dr.	3,00,000	 3,00,000

Note: Actually, the expenses are incurred in unrestricted revenue fund and reimbursed to the above.

Q39. Compare as per IGAAP-USGAAP-IFRS

(a) Balance Sheet

(b) Income Statement

Answer 39.

The comparative analysis of IGAAP-USGAAP-IFRS.

(a) Balance Sheet

Basis of Difference	IFRS	USGAAP	IGAAP
Format	IFRS does not prescribe any format, but stipulates minimum line items like PPE, Investment property, Intangible assets, Financial assets, Biological assets, inventory, receivables, etc.	US GAAP also doesnot prescribe any format , but Rule S-X of SEC stipulates for listed companies minimum line items to be disclosed either on face of Balance sheet or Notes to Accounts.	IGAAP provides two format of Balance Sheet-Horizontaland Vertical format (Part I ofschedule VI to the Companies Act, 1956).
Order	Under IFRS, lineitems are presented in increasing order of liquidity.	Under US GAAP,items in assets and liabilities are presented in decreasing order of liquidity.	In IGAAP, line items are presented in increasing order of liquidity.
Consolidation	Consolidation of Financial statements of subsidiaries is not compulsory until it is required under some other law or regulation.	Under US GAAP con-solidation of results of Subsidiariesand Variable interestentity (FIN 46R) is compulsory.	It is not mandatory for companies to prepare CFS under AS 21. However, listed enterprises are mandatorily required by listing agreement of SEBI to prepare and present CFS.
Current/Non-Current	An organisation hasan option to adopt Current or Noncurrent classi-fication of assets and liabilities	Bifurcation into current & non-current items is cumpulsorily required.	No such requirement

(b) **Income Statement**

Basis of Difference	IFRS	USGAAP	IGAAP
Format	IFRS does not prescribe any standard format for income statement but prescribes minimum disclosure includes revenue, finance costs, share of posttax results of JV andassociates usingequity method.	There is no prescribed format, SEC guidelines Rule S-X prescribe minimum line items to be shown on the fac of income statement & suggest 2 alternatives a) a single step format where expenses are classified by function and b) a Multiple step format where Cost of sales is deducted from sales	Under Indian GAAP no format is prescribed , but minimum line items have been specified in Part II of schedule VI to Companies Act, 1956 including Aggregate Turnover, Gross Service revenue for Commission paid to Sole selling agent, Brokerage and discount on sales etc.
Prior Period Items	A prior period item/error should be corrected by retro-spective effect by restatement of opening balance of assets, liabilities or equities	Mandates retrospective application of errorand requiresre statement of comparative opening balance with suitable footnote disclosure.	Requires separate dis-closure of prior period inthe current financial statement & no restate-ment of retained earnings arerequired.
Discounting	IFRS provides that where the inflow of cash is significantly deferred without interest, discounting is needed.	US GAAP also permits discounting in certain cases for instance discounting is done incase of loans, debentures, bonds and upfront fees	There is no concept of discounting under IGAAP.
Change in accounting policy	IFRS requires retro-active application for the earliest period practical and adjust-ment of opening retained earning.	Requires prospective application of change in accounting policy and proforma disclosure of effect on income before extraordinary items on the face of income statement as separate section. Only inspecific case retro-spective is applicable	Under IGAAP, effect for change in accounting policy is given with prospective effect, if the same is material.
Bifurcation of Cost	There is no specific provision in this regard	Total cost is required to be shown separately under : a) Cost of Sales b) Selling and Administration c) R & D	There is no specific provision in this regard. There are certain disclosure requirements under varied A Swhich should be complied.

Basis of Difference	IFRS	USGAAP	IGAAP
Extra ordinary Events	Disclosure isprohibited	Nature should be both : a) Infrequent b) Unusual Disclosed separatelyon the face of Income Statement net of Taxes after results from operations	Distinct from the ordinary activities of the enterprise and, therefore, are not expected to recur frequently or regularly. The nature and the amount of each extra ordinary item should be separately disclosed in the statement of P & L in a manner that it simpact on current profit or loss can be perceived.

Q40. Compare as per IFRS-USGAAP-IGAAP

(a) Cash Flow Statement
(b) Dividend on Equity Shares
(c) Investments
(d) Impairment of Assets
(e) Business Combinations
(f) Internally Generated Internal Assets

Answer: 40.

(a) CASH FLOW STATEMENT

Basis of Difference	IFRS	USGAAP	IGAAP
Exemptions	No exemptions	Limited exemptions for certain investment entities	Unlisted enterprises, enterprises with a turnover less than Rs.500 million and those with borrowings less than Rs.100 million
Direct/Indirect Method	Both allowed	Both allowed	Both allowed. Listed companies-Indirect method Insurance companies-Direct Method
Periods to be presented	2 years	3 years	2 years
Interest paid	Operating and financing activity	Operating activity (to be disclosed by way of a note)	Financing. In case of a financial enterprise, operating activities

Basis of Difference	IFRS	USGAAP	IGAAP
Interest received	Operating or investing activity	Operating activity	Investing. In the case of a financial enterprise, operating activity.
Dividends paid	Operating or financing	Financing	Financing
Tax payments	Operating	Operating(to be disclosed by way of a note)	Operating
Dividends received	Operating or investing	Operating	Investing. In the case of a financial enterprise, operating activity.

(b) Dividend on equity shares

IGAAP

Presented as a appropriation of profits. Dividends are accounted in the year when proposed.

US GAAP

Presented as a deduction in the statement of changes in shareholders' equity. Cash Dividends are accounted in the year when declared. Only in case of Stock dividend adjustments is done in accounts.

IFRS

Presented as a deduction in the statement of changes in shareholders' equity

Dividends are accounted in the year when declared

(c) INVESTMENTS

IGAAP: AS 13

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'

(A) Current Investments – Lower of Cost or Fair Value

(B) Long term Investments. – At cost. If Permanent decline then reduce the carrying value to declined FMV.

All changes in carrying value is taken to P&L

Reclassification – Long term to Current – at lower of cost and carrying amount

Reclassification – Current to Long term – at lower of cost and Fair Value

INVESTMENTS : US GAAP

(A) Held to Maturity – *At Cost*. (with discount or premium amortized over the effective yield basis). *Most Restrictive category*. securities can be so classified if there is positive intent and ability to hold (maintain the securities) till maturity.

(B) Available for Sale. – *At FMV*. Unrealized gain / loss due to Fair value are accounted under OCI. In case of Permanent decline, the reduction is taken to income statement.

(C) Trading Securities – *AT FMV.* Unrealized gains and losses are entirely taken to Income Statement.

Investment in unlisted securities is valued at cost .There are very stringent limitations on reclassification of Investments.

IF "HTM" securities are sold, use of this category is prohibited. *Provision for diminution (in value of the long-term investment) created in earlier years cannot be reversed, whereas in Indian GAAP it can be reversed.*

INVESTMENTS : IFRS

(A) Held to Maturity – *At Cost*. (with discount or premium amortized over the effective yield basis). *Most Restrictive category*. securities can be so classified if there is positive intent and ability to hold (maintain the securities) till maturity.

(B) Available for Sale. – *At FMV*. Unrealized gain / loss due to Fair value are accounted under OCI. In case of Permanent decline, the reduction is taken to income statement.

(C) Trading Securities – *AT FMV.* Unrealized gains and losses are entirely taken to Income Statement.

Investment in unlisted securities can be valued at FMV.

There are very stringent limitations on reclassification of Investments.

IF "HTM" securities are sold, use of this category is prohibited for next two years

(d) IMPAIRMENT OF ASSETS

Difference Criterion	**IFRS and IGAAP**	**US GAAP**
Timing of impairment review	Annually	Whenever events or changes in circumstances indicate that the carrying amount may not be recovered
Asset is impaired if	Recoverable amount < Carrying amount	Fair value < Carrying amount
Recoverable amount/ Fair Value	Recoverable amount ishigher of· • Net Selling Price • Value in use	Fair Value is the amount atwhich an asset or liability could be bought or settled in a current transaction between willing parties
Cash flows for calculating value in use/ fair value	Use discounted cash flows for calculating the value in use	Use discounted cash flows for calculating the fair value
Reversal of impairment loss	Whenever there is a change in the economic conditions	Prohibited

(e) BUSINESS COMBINATION

Indian GAAP:

If the combination satisfies the specified conditions, it is an amalgamation in the form of a merger (Pooling of Interest Method), else an amalgamation in the nature or purchase.

Pooling of Interest Method and Purchase Method allowed

US GAAP:

Acquisition of net assets that constitute a business or controlling equity interests of entities.

Prohibits Pooling of Interest.

IFRS:

Bringing together of separate entities or operations into one reporting entity.

Prohibits Pooling of Interest.

Issues	IFRS	USGAAP	IGAAP
Date of acquisition	When control is transferred	When assets received or equity issued	Date specified by the court or the purchase agreement
Valuation of assets and liabilities	Fair value	Fair value	In pooling of interests method-book valueIn purchase method-book value or fair value
Treatment of goodwill	Capitalize and test for impairment	Capitalize and test for impairment	Estimate the useful life and amortize accordingly
Negative goodwill	Recognized in the income statement	Reduce fair value of non-monetary assets	Disclose as capital reserve
Reverse acquisition	Acquisition accounting is based on substance. Accordingly legal acquirer is treated as acquiree and legal acquiree is treated as acquirer	Similar to IFRS	Acquisition accounting is based on form.Legal Acquirer is treated as acquirer and legal acquiree is treated as acquiree for legal as well as accounting purpose.

(f) INTERNALLY GENERATED INTANGIBLE ASSETS

Issues	IFRS	USGAAP	IGAAP
Research Cost	Charge off	Charge off	Charge off
Development Cost	Capitalize if criterion is met	Charge off	Capitalize if criterion is met